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NEW PAY PLANS FOR EXECUTIVES

How 100 Leading Companies Use Stock Options, Bonus Plans, Deferred Compensation, Pensions To Give Executives More Net Income at Lower Cost

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EXECUTIVE PAY PLANS was prepared for clients and is priced at $5, but a limited number of copies are being made available for free examination. Send $5 to Business Reports, Inc., Dept. EPP-40, 225 West 34th Street, N. Y. 1, N. Y., to obtain a copy postpaid. It may be returned within 10 days for full refund.

BOOK REVIEWS

Departmental Merchandising and Operating Results of Department Stores and Specialty Stores (1951 Edition)

By Raymond F. Copes. CONTROLLERS' CONGRESS, National Retail Dry Goods Association, New York, N. Y., 1951. Pages: 112; $5.00 to members of the Controllers' Congress and the National Retail Dry Goods Association; $15.00 to non-members, not eligible for N.R.D.G.A. membership; $25.00 to non-members, eligible for N.R.D.G.A. membership.

The report of 1950 departmental merchandising and operating results is the 26th such annual report issued by the Controllers' Congress. It presents tables of departmental operations of department stores and specialty stores, grouped both by size of stores and by Federal Reserve Districts. The 112-page paper-covered book contains such a wealth of factual information that it is difficult to highlight any of it. The number of contributing stores in this issue was 385 compared with 402 in the previous year.

The book is divided into five sections as follows:

Text and supporting charts.
Typical tables.
Top performance tables.
Regional data.
Publicity expense data.

The text material is excellent. Interspersed throughout the text are condensed tables, graphs and bar charts effectively presented with white figures and lines against a blue background.

The grouping of data by Federal Reserve Districts is a continuation of a feature which first appeared for the year 1946. The total-store publicity expense data appear for the second time. Inclusion of the publicity section in a report devoted exclusively to departmental data appears questionable because the Harvard report dealing with over-all operations of department stores and specialty stores is the logical place for non-departmental expense data. It is conceded, however, that the publicity expense data in the MOR is in a little more detail than in the Harvard report but, because the sample of stores is not identical with that used by Harvard and because there are some variations in the compilation methods, the expense ratios in the MOR do not agree with those in the Harvard report; one feels the need to reconcile them.

The report was prepared by the staff of the Controllers' Congress under the supervision of Walter J. Ettlinger, and under the

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BOOK REVIEWS

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general supervision of Raymond F. Copes, General Manager. It is an excellent reference work.

J. P. FRIEDMAN

New York, N. Y.

Operating Results of Department and Specialty Stores in 1950

By Malcolm P. McNair. Division of Research, HARVARD BUSINESS SCHOOL, Boston, Mass., 1951. Pages: vi + 58; $5.00.

The Harvard report dealing with 1950 operations of department and specialty stores is the 31st in an unbroken series dating back to 1920. The current issue was prepared from questionnaires submitted by 349 stores compared with 354 stores for the previous year. Although the report is primarily a reference work, the text is so well written that it can be read.

The report is divided into three main sections as follows:

I—Text material with supporting summary tables.

II—Detailed tables.

III—Special analyses.

The data appearing in the tables have become more useful each year, the main improvement in the current report being the introduction of the inter-quartile range (outer limits of the middle 50%) of figures. This added detail, in the reviewer's opinion, is a more useful device for evaluating the common figures than the top performance figures included by the Controllers' Congress in its annual departmental report of merchandising operations. Furthermore, whereas the top performance figures in the Controllers' Congress report appear in separate tables, the inter-quartile range in the Harvard report is shown adjacent to the common figures.

In several tables there has been an expansion of data dealing with personnel productivity, executives, and space productivity. There is also a special table dealing solely with productivity of personnel; while this is not a new feature, it is a table which should be consulted often by department store executives in view of rising expenses.

Section III presents special analyses as to productivity of space and personnel, the effect of branch store operations on total store operating results and the effect of the use of the LIFO method on inventory valuations and operating results.

A new feature in the section dealing with special analyses presents selected data by

(Continued on page 788)

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BOOK REVIEWS

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Federal Reserve Districts. These data, however, are on a more limited basis than that introduced by the Controllers' Congress in its report for 1947. Another new feature in this section is a table of spring and fall figures for a small number of factors such as markon, markdowns, gross margin, total expense, and turnover, all of which are presented by size of stores.

The 1950 report was prepared under the direction of Professor Malcolm P. McNair. It is an improvement on the excellent reports of previous years.

J. P. FRIEDMAN

New York, N. Y.

Foreign Tax and Trade Briefs

By Walter H. Diamond. FALLON LAW BOOK COMPANY, New York, N. Y., 1951. Loose leaf—supplemented; binder, up-to-date material and service for one year: $25.00.

Here is a new and different tax service designed to fill a long-felt need. This loose-leaf book covers the basic tax law in sixty-four foreign countries and should be of great assistance to any businessman engaged in foreign trade.

The publishers have announced that they will keep the information current through bi-monthly supplements and that the first supplement of approximately sixty pages has been prepared and will go out in a few days. The initial price of this book covers the cost of the first year's service.

The author, Walter H. Diamond, has had nearly twenty years of experience in the field of foreign trade, taxation and banking. He has been associated with the Foreign Funds Control Division of the United States Treasury, has been a foreign analyst for the Federal Reserve Bank of New York, and currently is foreign economist for one of New York City's largest commercial banks. In preparing this book, Mr. Diamond has performed a most difficult task in a manner which does him credit.

A moment's reflection suggests that there are two general methods of furnishing information regarding taxation and trade practices of foreign countries. One is to provide a detailed presentation of the law of the particular country including regulations, rulings and court decisions. This would require a service ranging in size from one to several volumes for each separate country. The other method is to give a broad view of the types of taxes in each country in as concise a manner as possible. This service follows the latter course. It is designed to supply tax information for each of the

(Continued on page 789)

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sixty-four countries classified under the following headings:

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With respect to each classification there is presented:

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To whom or to what it applies,
Exemption limits, and
Significant steps in rates.

The taxes on dollar remittances as well as the limitations on transfers of funds are also summarized for each country. In addition to information about taxes, this service includes certain other information concerning import licenses, exchange requirements, and credit and collection experience with respect to each country. Another helpful feature is the fact that wherever the amount of income determines the rate of tax to be applied in each bracket, these amounts are shown in the foreign currency and also in United States dollars at the prevailing rates of exchange. This makes it easy for the reader to apply the rates to his own problem.

The large number of countries considered is most impressive, and the author is to be commended on the wide scope of his study. The following area summary of the sixty-four countries considered may be of interest: Africa, five countries; Central America, six; Far East, nine; Middle East, five; North and South America, twelve; West Indies, seven; Western Europe, twenty.

A service of this type is particularly needed at the present time because the current rate of direct private investment abroad is the greatest in our history. Indeed, in 1950 an all-time record of $1.6 billion of

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Book Reviews

(Continued from page 789)

United States investments abroad was reached, and by now the accumulated amount of United States private capital invested in other nations exceeds $15 billion. Any businessman considering trade abroad is almost certain to find the tax laws of the area in which he is interested discussed in this service. Broad general information concerning foreign tax laws, which is often most difficult to obtain, is made instantly available to him in this service.

This reference work should be of especial value to exporters, importers, trade organizations, banks, brokerage houses, shipping and insurance companies, and corporations with foreign branches, affiliates and agents. It will enable an executive to form preliminary opinions regarding the most advisable method of dealing with customers in, or entering business in any of the sixty-four foreign countries covered. This service will indicate what problems need special study and advice. Indeed, it performs a valuable function in its listing of the types of taxes in each country, because, by knowing what the existing taxes are, the executive is in a position to make further inquiry regarding those which would affect his particular operations.

This service, then, aids in preliminary decisions. It is not a substitute for detailed analysis of the tax laws and trade practices of these countries, which analysis, of course, must be made before any decision is made as to the most advantageous method of operation in any foreign country. For all the purposes indicated, this service will prove of great assistance.

PAUL D. SEGHERS, New York City, and
CHARLES L. SAVAGE, Adelphi College

THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XXI *December • 1951* No. 12

Taxes—1951-1952

By BENJAMIN GRUND, C.P.A.

AT the technical meetings held by the Committee on Federal Taxation in October, two groups of talks were given. One of them dealt with procedures before the Bureau of Internal Revenue, the other with the Revenue Act of 1951. The subjects covered at these meetings met with a general request by the membership for each of the Committee members involved to write up his material.

In this issue, we present the latter group which includes five papers covering the principal amendments embodied in the 1951 Act, and a sixth devoted to the excess profits tax provisions, including the 1951 amendments, aside from the relief provisions. This group of papers emphasizes that the Revenue Act of 1951 superimposes upon an already complicated tax law many new, intricate and technical provisions. And it will be years before their ramifications are fully tested and understood.

BENJAMIN GRUND, C. P. A., has been a member of our Society since 1936 and of the American Institute of Accountants since 1937 and is a member of the New York Bar. He is Chairman of the Society's Committee on Federal Taxation and is currently serving as a member of the Society's Board of Directors. Mr. Grund is a partner of Seidman & Seidman, Certified Public Accountants.

The most pressing need in connection with our income tax laws at the present time is simplification. Until steps in that direction are effectively undertaken, the operation of our federal tax laws will leave much to be desired.

The amendments suggested by the Society's Committee during the consideration of the Revenue Act of 1951 by the Committee on Finance of the U. S. Senate were previously published in the September, 1951, issue of *The New York Certified Public Accountant* and the Society's Committee is gratified to note that many of their suggestions have found their place in the new Act.

Your Committee is planning on resubmitting many of the suggestions not previously acted upon, together with such additional ones as merit consideration, to the Congressional committees in connection with tax legislation that is under consideration for 1952. Members of the Society are urged to pass along to the Committee any suggestions that should be helpful for that purpose.

The other series of three papers on Treasury Department practice and procedure will appear in an early issue. It will present to our readers an excellent background of what is worth considering in representing their clients before the Treasury Department.

The Revenue Act of 1951

(Part 1)

By BERNARD STEINBERGER, C.P.A.

Increases in Rates

(Sec. 12(b); Sec. 400; I.R.C.)

The new Revenue Act increases the tax by 11% on taxpayers in the lowest bracket, comprising incomes below $2,000.00 after deductions and exemptions; by 11¾% on single persons with incomes above the lowest bracket but below $28,800, and on married persons with incomes of slightly less than twice that amount; for all other taxpayers the increase is 9% of the surtax net income after deducting the present tax liability from surtax net income. For example, a single person with a surtax net income of $50,000 has a tax liability thereon of $26,820, leaving a balance of $23,180 subject to the 9% increase. The effective date of the increase is November 1, 1951; calendar year taxpayers will pay approximately one-sixth (1/6) of the total increase during the calendar year 1951. The increase in the tax rates for the calendar year 1951 will be integrated in the tax rate tables for this year, so that separate tax computations will not be made on income received before and after November 1st, and, further, it will make no difference in the tax for 1951 whether income is received before or after November 1st.

No penalties will be imposed for underestimating taxes resulting from the increase in tax rates.

Withholding Tax Tables

(Sec. 1622, I.R.C.)

New withholding tax tables, effective November 1, 1951, are being issued by the Commissioner, and the new rate is 20%, instead of the old 18%. Under regulations to be issued by the Treasury, an employer and employee can agree to voluntary withholding of amounts in excess of those prescribed by the statute.

Gross Income of Dependents

(Sec. 25(b)(1)(D), I.R.C.)

Heretofore, if a dependent's gross income was $500.00 or more, the taxpayer lost a $600.00 dependency exemption; the amendment corrects this inequity—for years beginning after December 31, 1950, the dependent's gross income must be $600.00 or more before the exemption is lost.

Head of Household

(Sec. 12(c), I.R.C.)

Under the new Act the head of a household will be granted approximately one-half of the benefits of income splitting now available to married persons. The head of a household is defined as an individual who is not married and who maintains a household in which he lives, together with:

First: An unmarried child (including one legally adopted), stepchild or grandchild of the taxpayer;

or

Second: Any person who is a dependent of the taxpayer, as defined below.

BERNARD STEINBERGER, C.P.A., is a member of the Society and of its Committee on Federal Taxation. He is also a member of the New York Bar and of the American Institute of Accountants.

Mr. Steinberger is a partner in the firm of Simonoff, Peyser & Citrin.

This paper was presented at a technical meeting of the Society held under the auspices of the Committee on Federal Taxation, on October 16, 1951, at the Engineering Auditorium in New York City.

The unmarried child, stepchild or grandchild need not be a dependent of the taxpayer as defined in the Code; in other words, taxpayer may be the head of a household regardless of the gross income of such unmarried child, stepchild or grandchild. If married, such child, stepchild or grandchild must be a dependent, and must not file a joint return with his (or her) spouse. The dependent must be one for whom the taxpayer is entitled to an exemption for the taxable year, that is, such person must have a gross income of less than $600.00, more than half of the support must be supplied by the taxpayer, and one of the following relationships to the taxpayer must exist:

a. A brother, sister, stepbrother or stepsister

b. A parent or grand-parent

c. A step-parent

d. A nephew or niece

e. An uncle or aunt

f. A son-in-law, daughter-in-law, mother-in-law, father-in-law, sister-in-law, or brother-in-law.

The dependency exemption of $600.00 will still be granted to the taxpayer, even though the same dependent enables him to qualify as head of a household.

The head of the household must contribute more than half the maintenance costs of the household. Maintenance costs would probably include food, clothing and shelter. The person supported in such household must actually live there during the entire year, unless temporarily absent attending school, reasons of health, etc.

An individual is considered unmarried although:

1. he is legally separated from his spouse under a decree of divorce or separate maintenance,
2. his spouse is a non-resident alien.

However, a taxpayer whose spouse dies during the year is considered as married at the close of such year.

These provisions are effective with respect to taxable years beginning after October 31, 1951 and, therefore, are not applicable to returns filed for the calendar year 1951. The head of a household, in filing a tax return for years beginning after October 31, 1951, will compute his tax under new surtax tables which will automatically reflect the benefit granted. This will be lost, however, if the tax is computed by the Collector under Supplement T.

Family Partnerships

(Sec. 3797(a)(2), I.R.C.; Sec. 191, I.R.C.)

Congress has finally done something about the confusion existing in the courts and the Bureau on the status of family partnerships. It has provided relief under the new Act on the principle that where there is a real transfer of ownership, a gift of a family partnership interest is to be recognized for tax purposes without regard to the motives surrounding the transfer.

The new Act provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

The Act further provides that in case of any partnership interest created by gift, the terms of the partnership agreement with resepect to the allocation of income shall be controlling, except when the allocation is made without proper allowance of reasonable compensation for services rendered by the donor, and except to the extent that the allocation of income to the donated capital is out of proportion to that attributable to the donor's capital. Only in the case of such exceptions will the Commissioner have power to set up a reasonable allowance for the services rendered by the partners and for the balance of the income to be allocated according to the partners' respective capital investments.

For example, a father makes a gift to his son of a 25% partnership interest, retaining a 75% interest for himself; the partnership agreement provides for reasonable compensation for the father's services, but divides the remaining profits, if any, equally between them. The Commissioner would apparently have the limited power to allocate the remaining profits 25% to the son, 75% to the father.

The distributive share of a partner in the earnings of the partnership is not to be reduced because of absence due to military service.

These provisions with respect to family partnerships are effective ONLY for taxable years beginning after December 31, 1950. The Act specifically provides that no inferences are to be drawn from the fact that the new section is not expressly made applicable to taxable years beginning before January 1, 1951.

Where the taxable year of any family partner is different from the taxable year of the partnership, the following rules as to the application of the new provisions will obtain:

1) If the partnership's taxable year begins in 1950 and ends within or with ALL of the family partners taxable years which begin in 1951, then the new Act is effective as to all distributive shares of income derived by the family partners from such taxable year of the partnership. For example, the partnership files on a fiscal year basis—February 1, 1950 to January 31, 1951; all of the family partners file on a calendar year basis for 1951. The new Act is effective as to all the family partners for the calendar year 1951.

2) If the partnership's taxable year ending in 1951 ends within or with a taxable year of any family partner which began in 1950, then the new Act is not effective and the family partners will not have the benefits of the Act for such taxable year of the partnership. For example, the partnership files on a fiscal year basis—February 1, 1950 to January 31, 1951; one family partner files on a calendar year basis for 1951, but another family partner files on a fiscal year basis—July 1, 1950 to June 30, 1951. The new Act is not applicable with respect to the distributive shares of income derived by any of the family partners for such taxable year (February 1, 1950 to January 31, 1951) of the partnership.

Gain from Sale or Exchange of Taxpayer's Home

(Sec. 112(n) I.R.C.; Sec. 113 (b)(1)(K) I.R.C.; Sec. 113 (a)(9) I.R.C.)

Under the law prior to amendment if a taxpayer sold his home and purchased another, any gain on the sale would have been taxable.

The new law provides relief from this situation. When a taxpayer sells his principal residence and purchases another within one year, or when the new home is purchased within a year prior to the sale of the old, gain is to be recognized only to the extent that the selling price of the old home exceeds the cost of the new home. If the taxpayer builds, rather than buys, his new home, construction must begin within one year before or after the sale of the old home, and the new home must be occupied as taxpayer's residence within 18 months after the sale of the old home.

An exchange of one residence for another is considered a sale and purchase, permitting a taxpayer to use the new provision; similarly, an involuntary conversion resulting from destruction, condemnation or seizure is considered a sale and the subsequent conversion into another residence is considered a purchase.

The ownership of stock in a cooperative apartment corporation is considered as property used by the taxpayer as his principal residence if—

a) in the case of stock sold, the apartment which the taxpayer was entitled to occupy was used by him as his principal residence,

b) in the case of stock purchased, the taxpayer uses as his principal residence the apartment which he is entitled to occupy.

If the old home, which had cost the taxpayer $10,000, was sold for $20,000, the taxpayer, under the law prior to amendment, would have had a taxable gain of $10,000. Under the new law no part of the gain would be taxable if the new home was purchased by the taxpayer within the required period for $20,000 or more. If the new home cost only $18,000, the taxable gain would be $2,000.

The adjusted basis of the new home, however, must be reduced by the amount of gain not recognized upon the sale of the old home. Thus, in the case of the home which cost $10,000, and was sold for $20,000 and was replaced by a new home which cost $18,000, the adjusted cost of the new home would be $10,000, representing the cost of the new home, less non-recognized gain of $8,000. The holding period of the new home for determination of any subsequent capital gain relates back to the date of acquisition of the old home.

If a taxpayer purchases a residence and then sells it prior to the sale of his old residence, the said purchase and sale are not entitled to the non-recognition of gain provisions.

It should not be noted that a taxpayer cannot obtain the benefits of these provisions on more than one sale during any one year. However, for this purpose an involuntary conversion is not considered a sale.

Where a taxpayer's property is used both for business purposes and for his residence, only that portion used as a residence will be eligible for the non-recognition of gain provisions.

The benefits of the new provision are applicable to any taxpayer who sells his principal residence after December 31, 1950, even though a new residence may have been purchased prior thereto.

Non-Business Casualty Losses
(Sec. 122(d)(5), I.R.C.)

Under the old law non-business casualty losses arising from fire, flood, storm, etc., were not includible as part of a net operating loss deduction and could only be taken, therefore, in the year the loss was sustained. Under the new Act such losses sustained after December 31, 1950, are included in a net operating loss deduction or can constitute the entire net operating loss deduction and carried back or forward, as the case may be.

This provision is effective for computing net operating loss deductions in years ending after December 31, 1948.

Medical Expenses
(Sec. 23(x), I.R.C.)

Under the old law a taxpayer's medical expenses were deductible only to the extent that they exceeded 5% of adjusted gross income.

Under the new Act, for taxable years beginning after December 31, 1950, if either the taxpayer or his spouse is 65 years or over, the 5% limitation is removed, but only for medical expenses incurred for the taxpayer or his spouse. Thus, the medical expense deduction could consist of:

First: All medical expenses, without 5% limitation, for taxpayer and his wife;

and

Second: Medical expenses in excess of 5% of adjusted gross income for the care of dependents.

The maximum limitations of $1,250 per exemption, $2,500 for a separate return and $5,000 for a joint return remain unchanged.

Election to File Joint or Separate Returns
(Sec. 51(g), I.R.C.)

Under the old law married taxpayers could elect to file separate returns or a joint return but the election once made was irrevocable for the particular taxable year.

For taxable years beginning after December 31, 1950, the new Act permits taxpayers who have filed separate returns to file a joint return within three years from the due date of the return. The tax as shown on the separate returns must be paid in full, however, before filing the joint return. All payments, credits, refunds or other repayments made or allowed with respect to the separate returns are to be taken into account in determining the extent to which the tax based upon the joint return has been paid.

Any election made by either spouse in his separate return with respect to the treatment of any income, deduction or credit cannot be changed on the joint return if such election was irrevocable on the separate return.

If a taxpayer was married at the time of filing a separate return, he and his spouse may subsequently elect to file a joint return, even though at the time of such election they are legally separated.

If either spouse dies before the election to file a joint return is exercised, the joint return with respect to the decedent can be made only by his executor or administrator.

It should be noted that the new Act does not correspondingly permit taxpayers to amend a joint return through filing separate returns after the due date.

Election as to Standard Deduction

(Sec. 23(aa) (7), I.R.C.)

Heretofore, the election of the standard deduction or the itemizing of deductions was irrevocable for the particular taxable year.

The new Act provides that, effective for years beginning after December 31, 1949, taxpayer may elect to take or not to take the standard deduction, after the filing of the return of such year.

If the spouse filed a separate return for the taxable year, taxpayer's election will not be allowed unless the spouse makes a similar election consistent with that of the taxpayer, and, further, taxpayer and his spouse must consent to the assessment of any deficiency arising from such election, even though the assessment would otherwise be barred.

Service Men

(Sec. 22(b)(13) (A) (B), I.R.C.; Sec. 154, I.R.C.)

The exclusion from taxable income of all the pay of enlisted men and warrant officers and the first $200 per month paid to commissioned officers is extended by the new Act to compensation received while hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone. This provision is effective for taxable years ending after June 24, 1950.

Members of the Armed Forces dying while serving in combat zones or as a result of wounds, disease or injury incurred in a combat zone are forgiven the income tax for the year of death, and for all prior taxable years ending on or after the first day served in a combat zone after June 24, 1950, and income taxes for any year unpaid at the date of death.

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The Revenue Act of 1951

(Part 2)

By AUGUSTUS MORRIS, C.P.A.

New Planning Required on Individual Capital Gains

THE 1951 Revenue Act made a number of noteworthy changes in the treatment of capital gains and losses. For one, it raised the maximum rate from 25% to 26% for years beginning after October 31, 1951, for individuals and March 31, 1951, for corporations. But even more important for most individual taxpayers is the alteration made in the existing procedure of taking into account 50% of an individual's long-term capital gains and losses (on property held for more than six months) and 100% of short-term capital gains and losses (on property held for six months or less).

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The change was made in order to prevent taxpayers from using $1 of short-term capital losses to offset $2 of long-term capital gains. Instead of taking long-term capital gains and losses into account at 50%, *all* capital gains as well as losses will be taken into consideration at 100%, regardless of whether they are short-term or long-term. If there is an excess of net long-term capital gains over net short-term capital losses, the excess is reduced 50%. (Corporations aren't affected since their capital gains and losses are already taken into account at 100%.) This change in method of computation goes into effect for years beginning on or after October 20, 1951. By a queer quirk of law, the change in maximum capital gains rate for individuals doesn't go into effect until 11 days later, for years beginning after October 31, 1951.

How to Compute Taxable Gains and Losses

The first step is to separate all gains and losses into the short- and long-term classifications. Net the result of all long-term gains and losses, and all short-term capital gains and losses—all taken into account at 100%.

1. If the net results of both long-term and short-term transactions are gains, the net short-term capital gain is treated as ordinary income. The net long-term capital gain is reduced 50% and is subject to the maximum 26% ceiling.

2. If the total of long-term and short-term transactions each net out to a loss, the losses are merged. A maximum of $1,000 a year can be used to reduce ordinary income. Any unused losses can be carried over (at 100%) for five years.

3. If the net of long-term transactions is a loss, while the net of short-term transactions is a gain, the net long-term loss is offset in full against the short-term gain. If the short-term gain exceeds the loss, the excess is treated in full as ordinary income. If the long-term loss exceeds the short-term gain, the excess can be used in full to offset ordinary income up to $1,000 a year, and any remainder may be carried over for five years.

4. If the net of long-term transactions is a gain, while the net of short-term transactions is a loss, the loss offsets the full gain. If the gain exceeds the loss, the excess is reduced by 50%. If the loss wipes out the gain, the unused loss can be used to offset ordinary income for the year up to $1,000 and any unused loss can be carried over for five years.

Examples	A	B	C	D	E
Net long-term capital gains (or losses) at 100%	$2,000	$4,000	—$5,000	—$500	—$5,000
Net short-term capital gains (or losses) at 100%	3,000	—3,000	7,000	— 400	3,000
Gross income (or loss)	5,000	1,000	2,000	— 900	— 2,000
Deduction for 50% of excess of net long-term capital gains over net short-term capital losses	1,000	500			
Short-term capital gains (treated as ordinary income)	3,000		2,000		
Long-term capital gains taxable at no more than 26%	1,000	500			
Deductible losses				— 900	— 1,000*

* Limit for one year—remaining $1,000 could be carried over.

How the 26% Rate Applies

The new maximum rate of 26% applies to the excess of the net long-term capital gains over net short-term capital losses (all taken into account at 100%). In other words, it is 26% of the full excess of net long-term capital gains over net short-term losses. This means that the 26% ceiling rate will apply when the combined normal tax and surtax rate exceeds 52%. This will be when income (after deductions and exemptions) exceeds $14,000 for a single person, $28,000 for a married person and $22,000 for head of household.

Here is how the tax would be calculated assuming that a married taxpayer has ordinary net income after deductions and exemptions, of $37,500 plus $10,000 of long-term capital gains, $10,000 of short-term capital gains, and $15,000 of short-term capital losses. His tax for 1952 would be as follows:

Regular Tax:	
Ordinary income	$37,500
Excess of net long-term capital gains of $10,000 over net short-term capital losses of $5,000	5,000
	$42,500
Less 50% of excess of net long-term capital gains over net short-term capital losses ($5,000)	2,500
Net income	$40,000
Regular tax	$16,232
Alternative Tax:	
Net income (above)	$40,000
Less 50% of excess of net long-term capital gains over net short-term capital losses	2,500
	$37,500
Tax on $37,500	$14,757
Plus 26% of excess of net long-term capital gains over net short-term capital losses ($5,000)	1,300
Alternative tax ceiling	$16,057

This would be the tax due since it is less than the regular tax of $16,232.

Loophole Closing Gives Some Taxpayers an Advantage

While the change in treatment of capital gains and losses was designed to close the former loophole permitting $2 of long-term capital gains to be wiped out with $1 of short-term capital losses, the new procedure will give some taxpayers a better tax result than under the former law. A taxpayer who formerly had long-term losses could use only 50% of these losses. Now he can use 100%, both for purposes of offsetting short-term and long-term capital gains, reducing ordinary income and carrying over the loss.

For example, a taxpayer who had a long-term capital loss of $2,000 could use $1,000 to offset the current year's income under the old law. Under the new law, he can use $1,000 to offset current year's ordinary income, and another $1,000 to reduce next year's income.

New Tax Planning Approach for Capital Gains

The old taxwise methods of handling capital gains are no longer applicable under the changed method of taxing them. Formerly the goal was to (1) sell at a *gain* stock held for more than six months, (2) sell at a *loss* stock held for six months or less. This is no longer valid.

A long-term capital gain, to the extent not offset by losses, is still advantageous because only 50% of it is taxable. Since long-term capital gains not offset by losses are taken into account at only 50%, any capital losses which are used to offset long-term capital gains are in effect getting only 50% recognition. The major goal for taxwise handling of capital gains under the new law is to segregate them so that in one year there are only long-term capital gains, in another year short-term capital gains and both long- and short-term capital losses. In that way you pay tax on only 50% of the long-term capital gains while preserving in full the long-term capital loss for use next year.

If in one year there are both short and long-term capital gains, the goal should be to realize short-term capital losses to the extent of the short-term capital gains. Since the short-term capital loss will cut down the short-term capital gain, the result is the equivalent of an ordinary loss.

Here are some examples showing how proper planning can cut taxes: Let's assume that Mr. A realizes $10,000 of long-term capital gains, $10,000 of short-term capital gains, and $10,000 of long-term capital losses. If all realized in one year, Mr. A would be taxed on $10,000 of short-term capital gain—the equivalent of ordinary income.

If he could realize the long-term term capital gains in one year, the short-term capital gains and long-term capital losses in the next, he would be taxed on only $10,000 of long-term capital gain. Only half of this would be taxed and the maximum effective rate would be 26%. The same result would be reached if the long-term capital losses could have been realized as short-term capital losses.

Of course, this goal can't always be reached. But the nearer you can get to it, the better. Short sales can be used as an aid towards reaching this goal by deferring realization of gain or loss until the following year.

Realizing long-term capital gains in one year, and holding off capital losses for another can also be worth while even where there are no short-term capital gains. The reason is that segregation preserves full use of the losses. Take Mr. B who has $2,000 of long-term gains and $2,000 of short- or long-term capital losses. If he realizes the gains and losses in one year, the result is a zero effect.

If he realizes the losses in the first year, the gains in the next, the result is: First year—deduction of $1,000.

Next year—long-term capital gain of $2,000 less loss carry-over of $1,000;

less 50% of gain over loss ($2,000 less $1,000), or $500 of income.

Net effect over two years—deduction of $500 ($1,000 less $500).

If he realizes the gains in the first year, losses in the next, the result is:

First year—income of $1,000 (50% of $2,000)

Next year—deduction of $1,000 (limit)

Following year—deduction of $1,000 (carry-over of loss not used in previous year)

Net effect over three years—deduction of $1,000 ($2,000 less $1,000)

Timing Capital Losses Important

A short-term capital loss may, as pointed out above, be more valuable than a long-term capital loss. While they are both taken into account at 100%, a short-term loss is first used against short-term capital gains. However, a long-term capital loss must first reduce long-term capital gains. It may sometimes pay to realize a long-term loss in one year rather than the following year, so as to have that loss *carried over* as a *short-term loss* to the next year.

In 1952 Mr. C has paper losses of $8,000 on securities held for more than 6 months. In 1953 he expects to have long-term gains of $8,000 and short-term capital gains of $8,000. If the losses are taken in 1953, Mr. C will have to pay on ordinary income of $8,000. The losses will offset the long-term capital gains. If he realizes the losses in 1952 and carries over $7,000, the result will be to tax him on only 50% of the $8,000 long-term capital gains. The loss carried over will eliminate all but $1,000 of the short-term capital gains of 1953. The benefit of the first $1,000 will have been obtained in 1952.

Remainder of 1951 Requires Care

For the rest of 1951, the approach should be to realize long-term capital gains and short-term capital losses. Long-term capital losses should be postponed till 1952. By this procedure only 50% of the long-term capital gains will be taken into account while the short-term losses can be used in full to offset the long-term capital gains which have first been reduced 50% under the old law (a 2 for 1 break). Next year the long-term capital losses will be taken into account at 100%. If taken in 1951 only 50% of the loss would count.

Fiscal Year Partnerships Caught by New Law

The new capital gains treatment applies to years beginning after October 31, 1951. This means the year of the taxpayer. If a partner on a calendar year basis is a member of a fiscal year partnership (say a February 28 year), his share of the partnership capital gains will be treated under the law applicable to his year even though the actual gains or losses of the partnership were realized in 1951 before the enactment of the law. Thus, if the partnership for the year ended February 28, 1952 had long-term capital gains of $20,000 and short-term capital losses of $10,000, an 80% partner on the calendar year basis would have to pick up in his 1952 return, $16,000 of long-term capital gain and $8,000 of short-term capital losses. This would give him income of $4,000 ($16,000 less $8,000 reduced 50%). If the partnership year had ended December 31, 1951, the partner would have had no income. 50% of the $16,000 would be taken into account and this figure would be completely wiped out by the $8,000 short-term losses. One possible out for a fiscal year partnership which doesn't want its security transactions for the rest of 1951 to fall under the 1952 law, is to distribute its securities to the partners and let them make the sale personally.

Unharvested Crops and Fruit Given Capital Gain Advantage

The 1951 Revenue Act liberalized the law on capital gains and losses as

applied to farming activities. One change involves the treatment of gain on unharvested crops and unripe fruit when sold together with the land. The Bureau and Tax Court had ruled that the gain allocable to the crops and fruits was ordinary income because items were property held primarily for sale to customers. Two district courts felt that the fruit and crops were part of the real estate; that they constituted real property used in a trade or business; and that they were therefore entitled to the benefits of capital gain treatment (under Section 117(j)).

For all years beginning after December 31, 1950 the viewpoint of the district courts is frozen into law. The only statutory limitation is that the expenses of growing the fruit or crop are not deductible, whether incurred in the year of sale or prior years. They must be added to the basis of the property.

While the expense will be disallowed even if deducted in an earlier year, there is no provision extending the statute of limitations in regard to the year the expense was taken. Therefore, if the earlier year is closed, the taxpayer will apparently *not* have to eliminate the deduction even though he gets the benefit of an increased basis in the later year of sale. Practically, though, this situation will rarely arise.

Farmers Helped and Hurt on Breeding Cattle

The second change in the direction of farmers was in the tax treatment of the sales of breeding, dairy and draft animals, though this was not all in favor of the taxpayer. Most court decisions had permitted farmers to realize long-term capital gain on the sale of breeding, dairy and draft animals if held for six months or more. These were treated as depreciable business property (Sec. 117(j)). But the Treasury had made it difficult for farmers to get this advantage. It fought taxpayers on the ground that the cattle were held primarily for sale to customers and thus resulted in ordinary income when sold. The 1951 Act compromises the dispute.

Taxpayers were helped on one side. For all taxable years beginning after 1941 and before 1951, the law has been retroactively changed to specify that breeding, dairy and draft cattle are entitled to capital gains treatment (Sec. 117(j) if held for more than six months from the date of acquisition. It no longer matters that the cattle are destined for sale to customers after the breeding, dairy and draft period is ended. Nor is it material, as the Treasury contended, that the animal is sold before its full period of usefulness is over. This change should make it easier for farmers who didn't claim capital gain treatment to get refunds for open years.

The Treasury was given a nod for years beginning after 1950. In those years, taxpayers must have held the animals for twelve or more months rather than six months. And poultry is specifically ruled to be not eligible for the capital gains treatment given breeding, dairy and draft animals. This apparently confirms the treatment of poultry as a Sec. 117(j) asset for earlier years.

In order to forestall the Treasury from claiming that farmers who get this advantage must capitalize the expenses of raising the animals, or must inventory them, the Senate Report specified that the gains should be computed in accordance with the method of accounting used by the taxpayer and recognized by the Bureau.

Sales to Spouse or Controlled Corporation Hit

A sale of depreciable property at a profit between spouses or between a stockholder and his controlled corporation has been an effective method of stepping-up the basis of property at a capital gains cost without losing control of the property. The tax cost could be more than recovered through depreciation on the stepped-up basis. And

the depreciation could be used to reduce ordinary income in full.

The law was changed in an effort to block this tax saving. However, the door was left so wide open after the change that it is questionable whether the result of the 1951 Act wasn't to advertise the effectiveness of this tax-saving device rather than to discourage its use.

Gain from the sale or exchange of property which is depreciable property in the hands of the transferee will be considered ordinary income if the sale or exchange is made either directly or indirectly between (a) a husband and wife, *or* (b) an individual and a corporation of which he, his wife, minor children, and minor grand-children together own more than 80% in value of the outstanding stock. Since the ownership is not determined by any reference to indirect ownership through any other members of the family or through partnerships, corporations, etc., it is relatively easy to avoid this pitfall. For example, a father and adult son who own a corporation are beyond its bounds.

The new rule applies to years ending after April 30, 1951 but only to sales or exchanges made after May 3, 1951.

Collapsible Corporation Ban Extended to Inventories

The 1950 Revenue Act barred the tax maneuver of converting ordinary income into capital gain by the use of a so-called collapsible corporation. The procedure was to form a corporation to produce a picture or group of pictures, construct houses in a certain project, etc. When the result was accomplished, the corporation would liquidate and the assets would be turned over to the stockholders who would then make the sale. In this way, gain normally taxable as ordinary income could be converted into long-term capital gain. The drafters of the 1950 Revenue Act thought it sufficient to bar the collapsible corporation where corporations were formed or used to *manufacture, construct or produce property*. Congress overlooked the fact that the same maneuver was also used to convert profits on inventory or stock in trade into capital gains. The procedure was to transfer the commodity to a new or dormant corporation and then sell the stock of the corporation to the prospective buyer of the commodity, who would then liquidate the corporation. The result was to change the profit on the inventory into capital gain.

This loophole has now been closed by extending the collapsible corporation ban to cover corporations which buy property, that, in the hands of the corporation, is considered stock in trade, inventoriable property, or property held primarily for sale to customers.

The "inventory" provision applies to years ending after August 31, 1951, but only to gains realized after that date. Tax treatment of gains realized before September 1, 1951 will be determined without drawing inferences from the new coverage for gains realized after August 31, 1951.

Security Dealers as Investors

Security dealers may hold some of their securities for investment rather than for sale to customers. Such investment securities (stock, bonds, debentures, rights, etc.) would receive the benefit of a capital gain (or the disadvantage of a capital loss) if sold after more than six months. In order to prevent any tax-inspired switching from investment to inventory account or vice-versa, the law calls for an early clarification of intentions and denies any tax benefit from a subsequent change of mind.

The dealer is given 30 days after the date of acquiring a security (or after October 20, 1951, whichever is the later) to identify the security in his records as a security held for investment. His gain will be treated as a capital gain only if he identifies the

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The Revenue Act of 1951

(Part 3)

By MARTIN WOLMAN, C.P.A.

THE Senate, of its own initiative, added to the House Bill, a group of miscellaneous provisions, whose purpose was to correct certain specific hardships brought to its attention. Generally, these effect quite limited amendments to portions of already existing sections of the Code. This is a discussion of a number of these amendments. To be exact, there are ten, and their background would fill a book. For example, an entire tax service is devoted to the first provision. For the purpose of this review, however, the discussion will be brief and to the point.

Stock Distribution of Profit-Sharing Plans

Ordinarily, when an employer makes a contribution in the nature of compensation for the benefit of an employee, the employee is taxed in the year the contribution is made. To encourage incentive and retirement income plans, an exception was made to this rule in Section 165. This section, among other things, postpones taxation of the employee until the year when he receives his retirement benefit. This benefit may come as a regular pension, in which case the employee is taxed under the annuity rule. Or, the benefit may come in a lump sum distribution, paid in one year, in which case the employee may treat the distribution as long-term capital gain.

Suppose, however, the benefit comes in the form of stock of the employer-corporation. (Stock of the employer-corporation is defined to include stock of a parent or subsidiary of the employer-corporation.) The stock may have been contributed when its cost, for example, was $10. Suppose at date of distribution, its value was $50. Previously, the employee was taxed immediately (as long-term capital gain) on the entire $50. (Of course, any contribution by the employee reduces the recognized gain). Under the new amendment he is taxed on the $10 portion when received, but he is not taxed on the $40 appreciation until he disposes of the stock. This provision is effective with respect to distributions made after December 31, 1950.

Death Benefits to Employees

Under current law, life insurance proceeds paid by reason of death are excluded from gross income. This was previously limited by its terms to *life insurance* payments. The new amendment extends this exclusion to death benefits paid by an employer, based upon a pre-existing contract, up to a maximum of $5,000 per employee. Thus there can be several exclusions where the employee is severally em-

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ployed. If there is more than one beneficiary, the exclusion will be allocated. This provision is effective January 1, 1951.

Termination Payments to Employees

Some employment contracts provide for payments to the employee after the employment is over, based on a share of future profits or a percentage of future gross receipts. Under previous law such payments were taxed as ordinary income, even if the employee accepted a lump-sum settlement in one year. Under the new amendment, this lump-sum is treated as long-term capital gain, provided the taxpayer was employed for more than 20 years and held the contractual rights for at least 12 years. This provision is effective January 1, 1951.

Restricted Stock Options

The Revenue Act of 1950 added a new section (130A) to the Code, providing that a grant to employees of certain types of stock options would not create taxable income to the employees. These were called "restricted stock options", and were very strictly defined. One of the qualifying conditions is that the option price at the date of the grant must be at least 85% of the fair market value on the same date. A problem soon arose as to what was the date of the grant? when the board approved? or when the *stockholders* finally approved? This was important because the market value might vary substantially in the interim. The new amendment accepts the former date as effective for this purpose. This provision is retroactive to January 1, 1950.

Redemption of Stock to Pay Death Taxes

Under certain circumstances, redemption of stock can give rise to an ordinary taxable dividend under section 115 (G). The Revenue Act of 1950 amended this section so that redemption of stock held by an estate, in an amount sufficient to pay death taxes, would not be held an ordinary taxable dividend, *provided* the stock comprised 50% of the value of the net estate. The new amendment changes this requirement to 35% of the value of the *gross* estate. This provision is applicable to taxable years ending on or after October 20, 1951, the date of enactment of the Act, but only to amounts distributed on or after that date.

Basis of Joint and Survivor Annuities in Gross Estate

Under previous law, a joint and survivor annuity included in a decedent's gross estate was treated as a gift for basis purposes, so that for gain, for example, the basis was the donor's basis. The new amendment provides that the basis shall be value reported for estate tax purposes. For example, if the cost of the contract was $150,000 and its estate tax valuation is $100,000, the taxable portion of each annuity payment is $3,000, where it was formerly $4,500. This provision is effective only where the decedent dies after December 31, 1950.

Individuals Earning Income Abroad

Section 116(a) excludes income earned by citizens outside the United States (other than from the United States or any agency thereof), if they are *bona fide* foreign residents. This section is considered defective in two respects. *First*, the exclusion applies to residence for "an entire taxable year". Thus an individual who goes abroad, say February 1st, loses the exemption for his first year. The new amendment corrects this by granting the exclusion to any "uninterrupted period which includes an entire taxable year". The *second* defect concerns the strict definition, heretofore, of "bona fide residence", which was often fatal to individuals going abroad for fixed periods of time, say 18 to 36 months. The new amendment corrects this by providing that mere physical presence for a period of 17 out of 18 consecutive months in a foreign country is sufficient to qualify, and income earned during that entire

period will be excluded. This provision is applicable to taxable years beginning December 31, 1950.

War Losses

Generally, war losses are deductible as casualty losses in the year of loss in the amount of taxpayer's basis. Recovery of an earlier war loss is taxable income in the year of recovery, at fair market value, but limited to the tax benefit of the deduction. This rule operates satisfactorily where only one property is involved. Where two properties are involved, and only one is recovered, it works a hardship. The new amendment corrects this hardship by providing that, at the election of the taxpayer, the value of the recovered property will not be included in gross income for the year of the recovery; however, in such cases the tax for the year in which the deduction was taken is to be recomputed by reducing the deduction by the amount of the recovered property, taken at its depreciated cost or other basis on the date of the loss or its fair market value on the date of the recovery, whichever the taxpayer chooses, and the increase, if any, in the tax so resulting is to be added to the tax for the year of recovery. If the election is made under this provision, no interest is to be paid or assessed on resulting refunds or deficiencies. The amendment is applicable to taxable years beginning after December 31, 1941.

Foreign Tax Credit for Taxes Paid by Foreign Subsidiary

Previous law permits a domestic corporation to claim a foreign tax credit for income taxes paid by the foreign corporation to a foreign government in the proportion that the dividends bear to the profits, *provided* the domestic corporation owns a *majority* of the voting stock of the foreign corporation. The new amendment reduces the necessary percentage to 10%. This provision is effective January 1, 1951.

Foreign Estate—Tax Credit

Our estate tax reaches the personal property of a citizen or resident, whether located in this country or located abroad. Since foreign countries also tax property within its borders, double taxation can occur. Some relief already exists where estate tax treaties (conventions) are in effect. But they are not in effect in all cases. The new amendment removes this double taxation in all cases by providing for a statutory tax credit, and permitting the estate to take the larger of such statutory tax credit or that provided by the treaty. This provision is applicable to estates of persons dying after October 20, 1951, the date of enactment of this Revenue Act.

The Revenue Act of 1951—Part 2

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security as an investment in the proper manner (to be prescribed by regulations) within the time limit. He must also *act* in accordance with the identification. Thus, he may not (after the 30-day period) actually hold the security for sale to customers in the course of his business. Once it is labeled as held for investment, he forfeits irrevocably the benefit of an *ordinary* loss. There isn't any definition of what held for investment means. Apparently if the security isn't held for sale to customers, it is held for investment.

Banks, however, retain their present privilege of treating their losses from the sale of bonds, debentures, notes, etc., as ordinary losses where the total losses on such sales in the taxable year exceed the gains, irrespective of identification.

These rules apply to sales or exchanges of securities (stock, bonds, notes, debentures, rights) made more than 30 days after October 20, 1951.

The Revenue Act of 1951

(Part 4)

By BERTRAM E. GILL, C.P.A.

Disallowance of Surtax Exemption and Minimum Excess Profits Credit (Split-Ups)

Section 15(c), I.R.C., is a new provision added by the Revenue Act of 1951 disallowing the $25,000 exemption from surtax and the $25,000 minimum excess profits credit of a transferee corporation when a corporation, on or after January 1, 1951, transfers property (other than money) to a corporation created for the purpose of acquiring such property, or to a corporation not actively engaged in business at the time of such acquisition if, after such transfer, the transferor corporation or its stockholders, or both, are in control of the transferee corporation during any part of the taxable year of such transferee corporation. It will be observed that the transfer must be made by a corporation. Transfers by individuals or a partnership are exempt from this provision. Transfers prior to January 1, 1951, by a corporation are likewise exempt. This provision is not applicable to any transferee corporation if it can establish by a clear preponderance of the evidence that the securing of the surtax exemption and minimum excess profits credit was not a major purpose of the transfer. Control means the ownership of stock having 80% of the total combined voting power of shares of stock or at least 80% of the total value of the shares of all classes of stock of the corporation. Some indirect ownership rules also apply. In the event that a corporation should transfer all of its property to more than one corporation after January 1, 1951, and the transfer is deemed to be within this provision, one exemption and credit will be apportioned between the transferee corporations. These provisions apply only during excess profits tax years.

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Certain Distributions of Stock on Reorganization (Spin-Offs)

The new Section 112(b)(11), I.R.C., provides that a corporation may transfer some of its assets to a new corporation in a reorganization and distribute the stock (other than preferred) of the new corporation to its stockholders under certain conditions without requiring the stockholders to treat the distribution as taxable income. This provision is referred to as the "spin-off" section. The Revenue Act of 1924 first included such a provision. It was part of the tax law until it was deleted from the Revenue Act of 1932. Since 1931 distributions of stock in this manner have constituted taxable dividends to the stockholders to the extent of earnings and profits. Previous attempts in 1948 and 1950 to insert the "spin-off" provision in the law were unsuccessful. In order to establish the right to treat the distributions as tax-free, all corporations in the reorganization must have intended to continue the active conduct of a trade or business after the reorganization and the distribution must not be used principally as a device for the distribution of earnings

and profits. The Senate Finance Committee said it was economically unsound to impede spin-offs which break up businesses into a greater number of enterprises when undertaken for legitimate business purposes.

Section 113(a)(23), a new provision, states that the tax basis of the original stock must be apportioned between the original stock and the new stock received in such distribution.

The above amendments are applicable to taxable years ending after October 20, 1951, but only to distributions of stock made after October 20, 1951.

Income From Discharge of Indebtedness

Section 22(b)(9), I.R.C., has been amended so that it applies to all taxable years. Before the amendment the provision was scheduled to be inoperative for taxable years commencing after December 31, 1951. Section 22(b)(9) permits a corporation to exclude from taxable income a profit upon the discharge of its own bond indebtedness if it so elects. The taxpayer in such case must agree to reduce the tax basis of its properties. Before the change it was necessary for a corporation to make such an election at the time of filing its Federal income tax return for the year involved. The amendment gives the Commissioner of Internal Revenue discretionary power to permit the election to be made at a later time. Taxpayers in the past have found it to their advantage to apply as much as possible of the profit against non-depreciable property. The new provision requires the profit on the retirement of such bonds to be applied first against the tax basis of depreciable and depletable property before applying any part of the profit to non-depreciable property.

Section 22(b)(10) relating to profits on bonds retired by railroad corporations has been extended to December 31, 1954. Under this provision a railroad may treat as non-taxable income the profit on the retirement of its bonds when such income is deemed to have been realized by a modification or cancellation of indebtedness pursuant to court order in a receivership or Section 77 B bankruptcy proceeding. Railroads are not required to reduce the tax basis of property by such profits.

Surtax on Corporations Improperly Accumulating Surplus

By amendment of Section 102, I.R.C., relating to surtax on corporations improperly accumulating surplus the excess of net long-term capital gain over the net short-term capital loss is excluded in computing Section 102 net income. The adjustment, however, must be reduced by the Federal income tax on such excess, computed by finding the difference between the Federal income tax excluding the excess of net long-term capital gain over the net short-term capital loss from taxable income and the Federal income tax including such excess as taxable income. This provision is effective for years beginning after December 31, 1950.

Election as to Recognition of Gain in Certain Corporate Liquidations

Section 112(b)(7), I.R.C., as extended to the year 1952, provides that stockholders may elect to liquidate a corporation during any one month during the years 1951 and 1952 under a plan adopted after December 31, 1950. Each qualified individual stockholder must report as dividend income his profit on the liquidation to the extent of his pro rata share of earnings and profits, and as a capital gain his profit on the liquidation to the extent of cash or securities acquired by the corporation subsequent to August 15, 1950 reduced by the portion of profit taxed as a dividend. Each qualified corporate stockholder must report as a capital gain its profit to the extent of the greater of (1) portion of assets received by it which consists of cash and

securities acquired by the liquidating corporation after August 15, 1950, or (2) its pro rata share of earnings and profits.

This provision defers the reporting of taxable income. Generally, it can be used to advantage only when the liquidating coporation has a small amount of earnings and profits and has property which has greatly appreciated in value. Usually no advantage is gained if the liquidating corporation has a large amount of earnings and profits.

Involuntary Liquidation and Replacement of Inventories

Section 22(d)(6)(F)(iii), I.R.C., was amended by Section 306 of the Revenue Act of 1951. This amendment permits the replacement of lifo inventories involuntarily liquidated during the years 1941 to 1947, inclusive, to be considered as being replaced before the same type lifo inventory involuntarily liquidated during the period from July 1, 1950 to December 31, 1953, is replaced. Replacements of the World War II involuntary liquidations must be made by December 31, 1952 whereas the replacements of the Korean War period involuntary liquidations may be replaced any time before December 31, 1955. If there has been an involuntary liquidation of the same type of inventory during both periods, the tax law before amendment provided that the first replacement would restore the latest invasion of inventory, namely, that during the Korean War period. Due to the shortage of time for making the World War II replacements by December 31, 1952, the new provision states that the replacements must be made of the World War II invasions before replacement of the Korean War invasions.

Mutual Savings Banks, Building and Loan Associations, and Cooperative Banks

The Revenue Act of 1951 imposes a corporation income tax (normal tax 30%, and surtax of 22% on income in excess of $25,000) on certain mutual savings banks, building and loan associations, and cooperative banks, hereinafter called banks, for taxable years commencing after December 31, 1951. They are exempt from Federal excess profits taxes. Since many banks keep their books on a calendar year basis, they will become subject to Federal income taxes on January 1, 1952.

Between the present time and January 1, 1952, each bank should review its financial statements, especially its balance sheet, to determine whether or not it should sell certain assets at a profit before January 1, 1952, and thereby avoid paying a tax on such profit if realized after December 31, 1951. On the other hand, the sale of assets at a loss might be deferred until next year in order to secure the benefit of such loss for tax purposes. Depending in part upon the basis of accounting, expenses may be deferred until the year 1952 and thereby reduce taxable income. In the past the tax-exempt features of municipal bonds may not have been important but it is now a matter for consideration. In some states banks are allowed to purchase stocks. Banks will now be interested in securing the 85% dividends received credit on dividends received from domestic corporations. Generally only 15% of such dividends will be subject to tax.

Determination of the tax basis of each asset in the balance sheet should be made so that gain or loss can be readily computed. In general the tax basis of an asset is cost with certain exceptions. Some assets may have a tax basis even though carried on the books at no value. Consideration should be given to premiums on mortgage loans that have been expensed. By a special ruling the Treasury Department permits the amortization of premiums on F.H.A. mortgages (1951 P-H Federal Tax Service, paragraph 6432). In order to compute depreciation, the cost of bank buildings, furniture and fixtures, and office equipment must be

assembled especially if the bank has expensed these items in the past. Depreciation rates and reserves for depreciation to January 1, 1952, must also be determined. Some people take the position that there should be no reserve for depreciation to January 1, 1952, on the ground that such banks while tax-exempt had no depreciation allowed or allowable.

Net taxable income of a bank is computed with a few exceptions on the same basis as any other corporation. Book entries writing an asset down or up are ignored for tax purposes. The creation of reserves usually does not establish tax deductions. In some states these banks have been subject to state taxes and know the problems of transposing book income and expenses into taxable income and expenses. In addition to regular business expenses the banks will be entitled to certain deductions especially provided by the tax law, such as dividends paid or credited to depositors, and to amounts paid during the year in repayment of loans made prior to September 1, 1951, by the United States or any agency or instrumentality thereof which is wholly owned by the United States or by a mutual fund established under the authority of the laws of any State. Another exception is that if a bank sustains a net loss from sales or exchanges of bonds, notes, and other evidences of indebtedness issued by corporations and governmental bodies with interest coupons or in registered form, such net loss is treated as an ordinary loss instead of a capital loss (Sec. 117(i), I.R.C.). Deductions are allowed for bad debts either on an actual basis, that is, a deduction is allowed when the account is determined to be worthless and written off to expense or against a reserve, or on a reserve basis, if an election to take deductions on one or the other of these bases is made at the time of filing the first tax return.

The second sentence of Section 313 (e) of the Revenue Act of 1951 (amending section 23(k)(1), I.R.C.) provides that mutual savings banks, building and loan associations, and cooperative banks may claim as a deduction any amount added to the reserve for bad debts that they deem reasonable but limited to the lesser of:

(1) Net income for the taxable year without regard to the addition to the reserve

OR

(2) The amount by which 12% of the total deposits of its depositors at the close of the taxable year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the year.

An illustration of the limitation is as follows:

Limitation #1:

Net income before any addition to the reserve for bad debts for year 1952	$ 250,000
Amount allowable as an addition to reserve for bad debts for year 1952 under limitation #1	250,000

Limitation #2:

Total deposits of depositors at December 31, 1952	$10,000,000
12% of preceding line	$ 1,200,000
Sum of surplus, undivided profits, and reserves at January 1, 1952	1,000,000
Amount allowable as an addition to reserve for bad debts for year 1952 under limitation #2	$ 200,000
Maximum amount allowable as an addition to reserve for bad debts for year 1952, lesser of limitations #1 and #2	$ 200,000

However, it appears that when the second limitation (12% of total deposits) is applicable under the foregoing computations, the taxpayer may nevertheless claim (under the first sentence of Section 313(e) of the Revenue Act of 1951) an amount which constitutes a "reasonable addition to a reserve for bad debts—determined with due regard to the amount of the taxpayer's surplus or bad debt reserves existing at the close of December 31, 1951." The Senate Committee Report recommended that the limitation under this method should be determined, under regulations to be issued by the Commissioner. The Committee stated that if a moving average experience factor is used in determining the ratio of losses to outstanding loans, a 25-year period should be used, in lieu of the 20-year period used for commercial banks, if such a period shows that larger bad debt reserves are required. In other words, it appears that if an objective test, such as the moving average ratio, supports a greater addition to the reserve for bad debts, the taxpayer is not subject to the restrictions described in the preceding paragraph. This is supported by the following from pages 73 and 74 of the Statement of the Managers on the Part of the House, attached to the final Conference Report which said:

> "Where the sum of the institution's surplus, undivided profits, and reserves at the beginning of the taxable year equals or exceeds 12% of its total deposits or withdrawable accounts at the close of such year, any deduction for such year for a reasonable addition to a reserve for bad debts will be determined under the general provisions of Section 23(k)(1)."

The law itself is susceptible to the interpretation that a taxpayer can always claim a deduction under the "objective test" (the first sentence of Section 313(e) if it would result in a larger deduction than the amount determinable under the "taxpayer discretion test" (the second sentence of Section 313(e)). In view of the statement in the Committee Report, this matter will require further support and study before it can be completely relied upon. Apparently the banks subject to taxes for the first time in 1952 must recognize the reserve for bad debts accumulated on the books during the period for which they were not subject to tax—that is, years beginning before January 1, 1952. Under the circumstances the reserve for bad debts as of December 31, 1951, should be kept as low as possible.

Income Tax Treatment of Exempt Cooperatives

So-called exempt cooperatives become subject to Federal normal tax and surtax or the alternative tax under Section 117(c), I.R.C., commencing with years beginning after December 31, 1951. They will remain exempt from excess profits taxes. These cooperatives will compute their net income on the same basis as any other corporation but will be permitted to claim as deductions in addition to those claimed as business expenses, dividends paid on capital stock, patronage dividends paid during the year and patronage dividends paid by the 15th day of the ninth month following the close of its taxable year if such patronage dividends relate to the taxable year. Such dividends may be taken only in one year.

In addition the new provision provides that information returns must be filed for the year 1951 when patronage dividends of $100 or more are made whether such dividends are made in cash, merchandise, stock indebtedness, letters of advice, etc. The Commissioner of Internal Revenue recently by regulation imposed the very same obligation on cooperatives; that is, of reporting patronage dividends of $100 or more paid during 1951.

The Revenue Act of 1951

(Part 5)

By PHILIP BARDES, C.P.A.

I—Changes in Rate

THE Revenue Act of 1951 increases the corporation normal tax from 25 per cent to 30 per cent effective for taxable years beginning after March 31, 1951. For the calendar year 1951 the specific rate of 28¾ per cent is provided in the Act. For fiscal years beginning before April 1, 1951, and ending after March 31, 1951, two tentative taxes are computed, one at the old rate and the other at the new rate, and then each is prorated according to the number of days before April 1 and after March 31, respectively. The sum of the two taxes thus prorated is the actual normal tax payable. The surtax rate remains unchanged at 22 per cent of surtax net income over the $25,000 surtax exemption. (Section 121 amending Sections 13 and 15, I.R.C.)

A new ceiling is set on the amount of excess profits tax to be paid and the method of computing the ceiling is changed by the new law. Under the Revenue Act of 1950 the excess profits tax was the lesser of

(1) 30 per cent of the adjusted excess profits net income, or

(2) the excess of 62 per cent of the excess profits net income over the amount derived by multiplying the excess profits tax net income by the normal and surtax rates.

For years beginning after March 31, 1951, the maximum tax is an amount equal to 18 per cent of the excess profits net income. For the calendar year 1951, a specific ceiling rate of 17¼ per cent is provided. For fiscal years "straddling" April 1, 1951, the ceiling is computed under the old way and under the new way and the two amounts prorated according to the number of days before April 1 and after March 31. (Sections 121 and 131 amending Section 430, I.R.C.)

The 18 per cent ceiling is operative when excess profits net income is more than 2½ times the amount of the credit.

A. Fiscal Year Corporations

Corporations with fiscal years ending after March 31, 1951, but prior to October 1, 1951, are required to file returns on or before January 15, 1952, reflecting the changes made by the new law, regardless of whether or not they filed timely returns under the law in effect on the date such returns were due. The return filed on January 15, 1952, will be considered to be the return for the preceding fiscal year, taxes are due on that date in lieu of the time prescribed in Section 56(a) of the Code and all payments made prior to that date will be considered as having been paid on that date. Thus the statute of limitations will not start to run until January 15, 1952 (Section 124).

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As previously pointed out fiscal year taxpayers with years "straddling" April 1, 1951, must compute two tentative taxes prorating on the basis of the portion of the year covered by the old rates and the portion covered by the new rates to arrive at a final tax. However, the Revenue Act of 1950 was effective July 1, 1950, and the Revenue Act of 1951 is effective April 1, 1951. Therefore corporations with fiscal years beginning before July 1, 1950, and ending after March 31, 1951, are subject to three sets of tax rates. In such cases, three tentative taxes must be computed. In the case of a western hemisphere trade corporation, a public utility which has paid dividends on its preferred stock or any corporation which has received dividends on the preferred stock of a public utility with respect to which a credit is allowed, the amount of the normal tax net income and the amount of the surtax net income will be different for each of the three computations. (Section 131 amending Section 108, I.R.C.)

II—Net Operating Loss Carry-Over

The Revenue Act of 1950 amended Section 122 of the Internal Revenue Code to permit a five-year carry-forward and one-year carry-back of net operating losses in lieu of the two-year carry-forward and two-year carry-back previously permitted. The 1950 Act, however, only affected net operating losses incurred in years beginning after December 31, 1949. Operating losses incurred in 1948 and 1949 could only be carried forward two years. The 1951 Act permits a three-year carry-forward of net operating losses incurred in years beginning after December 31, 1947 and before January 1, 1950, thus extending for one year the period in which 1948 and 1949 operating losses can be used to reduce taxable income. (Section 330 amending Section 122, I.R.C.)

III—Excess Profits Tax Relief

Most of the new relief provisions enacted by the 1951 Act are tailor-made to fit particular cases wherein it was felt that inequity would result if relief were not provided. The great majority of taxpayers will receive no benefit from these sections. The Senate Finance Committee realizes that additional work must be done and has stated in its report that action was only taken in those cases presenting the most pressing and immediate need for statutory change. Action was deferred on a number of meritorious proposals pending the filing of excess profits tax returns and an evaluation of the detailed operation of the law. The staff will continue its study of the problems involved and it is anticipated that action will be taken early in 1952. The relief sections adopted, all of which are effective retroactively to all taxable years ending after June 30, 1950, are:

A. Ceiling on Excess Profits Tax of New Corporations — *(Section 501 amending Section 430, I.R.C.)*

A series of special ceiling rates is provided for the first $300,000 of excess profits net income of a new corporation during the first 5 years of its existence. On income above $300,000 the 18 per cent ceiling provided for ordinary corporations is applicable but on the first $300,000 of income in the case of new corporations the ceiling rates are considerably lower, ranging from 5 per cent to 14 per cent, as follows:

1st year.....	5%
2nd year.....	5%
3rd year.....	8%
4th year.....	11%
5th year.....	14%

The relief provided by this amendment is available to corporations formed after the base period as well as those formed prior to December 31, 1949. The section is retroactive to 1950, the first excess profits tax taxable year. The special ceiling rates are not available to new corporations created as a result of either a tax-free reorganization or a taxable transaction

where the successor corporation would be entitled to use its predecessor's base period experience, unless the predecessor corporation was itself eligible for the special ceiling rates. Thus, the new corporation will determine its eligibility on the basis of when its predecessor commenced business. The ceiling rates are also not available to companies engaged primarily in government business or to corporations which are controlled by persons owning an old corporation engaged in the same business. The provision can only apply to corporations started after July 1, 1945, because if formed on or before that date, the first excess profits tax taxable year would be the corporation's sixth year.

B. Base Period of Fiscal Year Corporations—*(Section 503 amending Section 435(d), I.R.C.)*

Under the 1950 law, fiscal year corporations with fiscal years ending after December 31 but before April 1 are permitted to use as their base period the 48 months ending with their last taxable year ending prior to April 1, 1950. However, taxpayers with fiscal years ending after March 31st were required to use the 48-month period ending December 31, 1949. The 1951 Act permits taxpayers with fiscal years ending after March 31, 1950, to use, for purposes of the general average method, the 48 months ending with March 31, 1950, if such base period results in a lesser tax. However, whenever it is necessary to use the income of a fiscal year ending after June 30, 1950, for purposes of computing earnings for the optional period, the income of such a year must be reduced according to the percentages provided in Section 435(e)(2)(E) of the Code.

C. Growth Formula for New Corporations — *(Section 504 amending Section 435(e), I.R.C.)*

The use of the alternative average base period net income based on growth is extended to corporations which commenced business during the base period. Because many new corporations have only limited assets, to which they can apply the industry rate of return, it was believed that the relief provided by Section 445 of the Code was inadequate and that the growth characteristics of a new corporation should be recognized. A corporation formed after 2 years of the base period elapsed but before the end of the base period will automatically qualify because qualification is based on comparison of total payroll or gross receipts for 1948 and 1949 with 1946 and 1947. Similarly, a corporation formed late in 1946 or during 1947 should have little difficulty in qualifying because figures for 2 full years of business in the last half of the base period will be compared with gross receipts and payroll for a shorter period during the first half of the base period. Gross receipts and payroll for any period during which the corporation was not in existence will be taken into account as zero. Likewise, since it was not in existence on the first day of its base period, its total assets on that day are considered zero for purposes of the $20,000,000 total assets test.

D. Special Growth Formula Qualification — *(Section 505 amending Section 435(e), I.R.C.)*

Taxpayers qualifying under the new products test were permitted by the 1950 law to use an alternative growth formula based on the income for the last 6 months of 1948 and the first 6 months of 1950. As the law was written, however, taxpayers were entitled to this special formula if they qualified only under the new products test. The 1951 Act eliminates the word "only" so that taxpayers qualifying under the new products test may use the special formula even if they also qualify under the payroll or gross receipts tests.

E. Reduction of Inadmissible Assets —*(Section 507 amending Section 435(g), I.R.C.)*

Under the 1950 law a decrease in inadmissible assets had no effect on the

income credit except as an offset to a capital reduction for the year. Thus, if a taxpayer using the income credit disposes of a substantial amount of such securities and invests the proceeds in plant and equipment, the earnings from these additional operating assets are subject to excess profits tax, but there is no offsetting increase in credit because of the new facilities. The 1951 Act provides that in computing the income credit, reductions in inadmissible assets subsequent to the base period are allowable as capital additions if the proceeds are invested in tangible inventory items or tangible property used in the taxpayer's trade or business.

F. Abnormalties During Base Period—*(Section 509 amending Section 442, I.R.C.)*

The 1950 law provided relief to taxpayers whose production or operation was interrupted or diminished in a base period year by the occurrence in that year or immediately prior thereto of events unusual and peculiar in the experience of the taxpayer. The 1951 Act provides an alternative eligibility requirement for the reconstruction of earnings for one of the base period years based upon the application of the industry rate of return to total assets at the end of such year. Under the 1951 Act, if earnings for the third-best base period year are less than 35 per cent of the average earnings in the two best base period years, and an interruption to operation occurred in the year prior to the depressed year, the taxpayer may substitute the industry rate of return for the actual earnings in the depressed year. Earnings for the year reconstructed may not exceed the average of the two best base period years. However, under this alternative added by the 1951 Act, earnings for the reconstructed year are not subject to the requirement that they must exceed 110 per cent of the actual earnings of such year.

G. Eliminating Duplication in Computation of Total Assets—*(Section 510 amending Section 442(f), I.R.C.)*

Under the 1950 law, a parent corporation did not lose any excess profits credit because of loans to subsidiaries not evidenced by notes; yet the funds so borrowed on open account could be used by subsidiary companies as part of total assets for purposes of applying industry rates in computing return under the various relief sections. This resulted in duplication of credit in certain instances. The 1951 Act provides that total assets shall not include funds borrowed on open account from a parent corporation or one under common control with the taxpayer.

H. Change in Product — *(Section 511 amending Section 443(f), I.R.C.)*

The 1950 law provided relief if a new product, introduced during the last 3 years of the base period, accounts for more than 40 per cent of gross income or 33 per cent of net income and net income increased 25 per cent within 3 years after the change. The 1951 Act extends this relief to the special situation where the new product was not introduced until after the close of the base period but where construction of facilities for the production of the product was begun before July 1, 1950 in furtherance of a contract executed prior to the end of the base period licensing production of the product.

I. Total Assets of New Corporation During First 3 Years — *(Section 512 amending Section 445(c), I.R.C.)*

Under the 1950 law, the formula for computing relief for a new corporation during the first 3 years of its existence resulted in only 75 per cent of its borrowed capital being included in the base to which the industry rate of return was applied. The 1951 Act permits the application of the industry rate

of return to equity capital plus 100% of borrowed capital in computing the credit of a new corporation during any of its first 3 years. This brings the relief accorded a new corporation during its first 3 years in line with that of other new corporations and with that of corporations using other relief sections involving the industry rate of return. Interest on 100% of borrowed capital must be deducted in computing the credit.

J. Transition from World War II Production—*(Section 516 adding Section 459(a), I.R.C.)*

This is designed to provide relief for companies that had difficulties during 1946 and 1947 in converting from war production and did not reach substantial peace-time production until late in the base period. However, comparatively few corporations will be able to meet the rigid requirements, which are:

1. Commencement of business before January 1, 1940.
2. Adjusted basis of real property and tangible depreciable property not in excess of 10 million dollars on the first day of the base period.
3. 70 per cent of income for 1942 through 1945 attributable to government contracts but less than 20% of (1) base period and (2) 1950 income attributable to such contracts.
4. Unadjusted basis of real property and tangible depreciable property at end of base period 250 per cent or more of basis of such property at the beginning of the base period.
5. Profits in 1945 and average of 1948-49 profits 300 per cent of average 1946-47 profits.

Corporations qualifying will be permitted to use an income credit based on one-half of 1948 income plus 40 per cent of 1950 income (different percentages of 1950 income in the case of certain fiscal year corporations).

K. Physical catastrophe in Base Period—*(Section 517 adding Section 459(b), I.R.C.)*

This provides relief where a catastrophe such as an explosion or fire destroyed, during the last 3 years of the base period, facilities of a plant or plants accounting for at least 15 per cent of a corporation's total facilities, and substantially interrupted normal production or operation for a period of more than 12 consecutive months. Although, such an event would qualify a taxpayer for relief under Section 442 of the Code, the relief afforded by that section, based on industry rates of return, would not be adequate where base period experience prior to the catastrophe indicates that the taxpayer would probably have earned in excess of the industry rate if it had not been for the catastrophe. A corporation qualifying for relief under this new section may either substitute average excess profits net income of the base period, prior to the year in which the catastrophe occurred, for its earnings during the year in which the catastrophe occurred; or, may use as its average base period net income, an amount computed as in "J" above, whichever method results in the lesser tax.

L. Special Relief for Television Broadcasting Companies — *(Section 519 adding Section 459(d), I.R.C.)*

This section allows corporations which derived part of their gross income from television broadcasting and part from some other business, such as radio broadcasting, an alternative method of computing their average base period net income for excess profits tax purposes. The alternative method requires the segregation of the average base period net income from the radio or other business, from the average base period net income (or deficit) from television. In lieu of such average base period net income (or deficit) from television, there is sub-

stituted a constructive average base period net income based either on the radio industry rate of return or a self-computed radio rate of return.

The self-computed rate of return is derived by dividing the average base period net income from radio as computed under Section 435(d) by the average base period radio assets. Either of these rates of return is applied to total television assets, held at the end of 1949, or at the end of the first calendar month prior to 1951, during which the taxpayer commenced its television broadcasting, whichever is later. The result is presumed to be what the company would have earned had it invested in the radio broadcasting business amounts equivalent to those expended in the acquisition of television assets. Such constructive earnings are then added to the actual average base period earnings from nontelevision activities to ascertain the amount on which the income credit is based.

M. Increase in Capacity—*(Section 520 amending Section 444(f), I.R.C.)*

This permits an increase in capacity for production or operation to be related back to the last day of the base period for purposes of qualification for relief under Section 444 of the Code if a factory or facility was completed during the first year ending after June 30, 1950 and prior to the end of the base period more than 40 per cent of the construction had been completed and the completion was in accordance with a plan to which the taxpayer was committed prior to the end of the base period.

IV—Acquisition of Property in Taxable Transactions

(Section 521 Adding New Part IV to Subchapter D of Chapter I, I.R.C.)

Part II, added by the 1950 Act, provides rules under which an acquiring corporation in certain tax-free exchanges may use the earnings experience of a predecessor corporation in computing its base period average earnings. Part IV, added by the 1951 Act, provides rules wherein, similarly, in certain taxable transactions, the purchasing corporation may use all or part of the base period earnings experience of a previous owner of assets acquired. Basically, where new funds are used to acquire all or substantially all of the assets of a sole proprietorship, partnership or corporation, the earnings experience attributable to the assets may be used by the purchasing corporation. Where two or more corporations join in a purchase, under certain conditions the predecessor's earnings experience may be divided. Further, a purchasing corporation is not to be denied the use of the earnings base of a predecessor merely on the grounds that a franchise or license, which was an important source of income of the predecessor, cannot be transferred from the predecessor to the purchaser but must be separately acquired by the purchaser from the licensor. The benefits of Part IV are limited to taxable exchanges occurring before December 1, 1950. Part IV is optional and need only be used if it increases the credit. Thus, since use of the growth formula is not permitted in conjunction with Part IV, the purchasing corporation may, if it commenced business before the end of the base period, find it more advantageous to use the growth formula based solely upon its own base period earnings experience.

V—Reduction of Income Credit

(Section 602 Amending Section 435(a), I.R.C.)

The percentage of the average base period net income allowed in the determination of the credit based on income is reduced from 85 per cent to 83 per cent applicable to taxable years beginning after June 30, 1951, and is reduced to 84 per cent applicable to the calendar year 1951. Proration between 85 and 83 per cent is required for other taxable years beginning before and ending after July 1, 1951, based upon the number of days in the taxable year, before and after that date.

The Excess Profits Tax Provisions of the Internal Revenue Code
(Other Than Relief Provisions)

By CHARLES H. FRIEDRICH, C.P.A.

Introduction

IN the preparation of this paper I have assumed that since most of you are accountants or attorneys you have a general understanding of the Excess Profits Tax Act of 1950. I felt, therefore, that the best approach would be a discussion of the unusual or controversial points in the Act, and of course any means of minimizing taxes which I can point out to you.

Since this paper covers the whole Excess Profits Tax act except for the relief provisions, I have organized my comments by Sections of the Act and shall proceed in numerical order. I shall also comment briefly under the appropriate section headings upon the excess profits tax amendments in the Revenue Act of 1951.

Part I

Section 430—Imposition of Tax

This section, among other things, provides an over-all 62% ceiling for income and excess profits taxes to be effective for any period up to April 1, 1951. Thereafter, a ceiling of 18% applies to excess profits tax only. The Revenue Act of 1951 also provides a special ceiling for new corporations which is effective for the first five years after the corporation commenced business. This special ceiling limits the excess profits tax to 5% of excess profits net income not in excess of $300,000 in the first and second year, and then gradually increases each year until it reaches 18%.

There is some controversy as to what interest adjustment, if any, is required in arriving at excess profits net income, where the company is subject to the ceiling. Some authors have suggested that no interest adjustment is required under such circumstances. It is similarly argued that no interest adjustment is required where the $25,000 minimum excess profits credit is used.

Section 431—Adjusted Excess Profits Net Income

This section which defines adjusted excess profits net income brings out the point that the $25,000 minimum exemption incorporates within it any unused excess profits credit.

Section 432—Unused Excess Profits Credit Adjustment

Since excess profits tax was only effective for approximately one-half of the calendar year of 1950 an adjustment must be made in the unsued excess profits credit for any year beginning before July 1, 1950. The unused credit for such year is proportionate to the part of the year subject to excess profits tax. Thus, the unused excess profits credit for the calendar year 1950 is approximately 50% of the excess of excess profits net income over the credit. Likewise in the case of the carry-back of unused excess profits credit, for a year beginning before July

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1, 1950, approximately 50% of the carry-back will be deemed to have been used in 1950, and the remaining 50% may then be carried forward to the five succeeding years.

In connection with the determination of carry-overs, although Section 456 permits the exclusion from excess profits net income of abnormal income attributable to other years, such exclusion is only for the purpose of computing the tax of the particular year. No such exclusion is permitted for the purpose of increasing an unused excess profits credit. There was a Tax Court decision on this point under a similar World War II provision.

Where a taxpayer has an unused excess profits credit carry-back and has filed a 90 day claim on Form 1139 with respect to such carry-back, it may be advisable to file a claim on Form 843 after the money has been received on the quick claim. The reason for this is that a Form 1139 does not start the running of interest. Therefore, if there is any possibility that subsequent changes in either income or excess profits credit might increase the amount of the claim, it would be necessary to have filed the Form 843 in order to start the interest running on any additional amount to be claimed. A carry-back claim which eliminates a prior year deficiency does not erase all of the interest on such a deficiency.

The Second Circuit Court under World War II law held that a corporation resulting from a statutory merger under New York law was entitled to the unused excess profits credits of its two predecessors. In view of this case it may be advisable to accomplish a combination of two or more corporations through a statutory merger, instead of a liquidation or purchase of assets. Since it may be doubtful that the Second Circuit's reasoning would apply to an operating loss, it might be advisable to have a downstairs merger, if a subsidiary has both operating losses and an unused excess profits credit.

Section 433—Excess Profits Net Income

With respect to the adjustment for interest on borrowed capital it should be noted that the premium or discount on bonds issued by a corporation is considered to be an adjustment of interest over the life of the bond. (*San Joaquin Light and Power Corp.* v. *McLaughlin*, 65 F.(2d) 677). Thus it appears for excess profits tax purposes interest should be increased by the amortization of discount and decreased by the amortization of premium.

In lieu of the regular net operating loss carry-over a taxpayer computing its credit under the income method or historical invested capital method may elect to claim its unused base period losses as a special operating loss deduction in the years 1950 and 1951. This special net operating loss requires an irrevocable election for the years concerned. Thus a taxpayer would be precluded from later claiming for that year the regular net operating loss deduction, or the asset approach invested capital method.

Section 434—Excess Profits Credit in General

A foreign corporation which was engaged in business in the United States during the entire base period may compute its credit under the income method or under the asset approach invested capital method. It is denied historical invested capital. In addition, under the asset approach it is also denied the recent loss adjustment.

Section 435—Excess Profits Credit Based on Income

This section covers the determination of the excess profits credit under the income method. Two rules are provided for averaging base period net income, the first being the general average, and the second being a special method for a limited class of corporations.

The Revenue Act of 1951 adds to the general average method an alternative

base period for corporations with fiscal years ending during the last 3 quarters of 1950. Such corporations may use an alternative base period, consisting of the 48 months ending March 31, 1950. However, if this computation reflects income of a taxable year ending after June 30, 1950, the income allocated to January, February, or March, 1950, is to be scaled-down as provided in Section 435 (e)(2)(E).

In addition, the 1951 Act made the growth formula available to corporations beginning business during their base period. This, however, is subject to restrictions in the case of acquiring corporations under Part II. Under the Excess Profits Tax Act of 1950 the growth formula was limited to corporations commencing business before the beginning of their base period.

Since qualification for the growth formula is determined by a comparison of aggregate payrolls or sales for the first and last halves of the base period, a corporation which begins business during the last half of the base period may expect to qualify automatically for the use of the growth formula, under either the gross receipts or the payroll tests. As the time of beginning business moves closer to the beginning of the base period, however, the volume of gross receipts or payrolls to be compared with the last half of the base period increases, and the percentage tests to be met are more realistic and significant.

In determining a taxpayer's qualification under the growth formula, time can be saved by first computing the relief to which the taxpayer would be entitled under this method, before computations are made to determine whether the taxpayer is entitled to use this method. If the growth method provides no relief, it follows that no further computation be made.

Whether the assets of an affiliate are to be included for purposes of the $20,000,000 test under the growth formula, is determined by the status for the first excess profits tax taxable year, although the amounts of assets are computed at the beginning of the base period of the taxpayer. If a calendar year corporation was not a member of an affiliated group in 1950 and had total assets of $20,000,000 or less on December 31, 1945, it may qualify for use of the growth formula. Even though it becomes a member of a large affiliated group in 1951 or later, it does not lose this privilege. On the other hand, if such a corporation was a member of a large affiliated group in 1950, it may be precluded forever from use of the general growth formula, even though in 1951 or later the affiliation is broken by sale of the stock of the taxpayer.

Section 441 relating to distributions in the first 60 days of the taxable year states that such distributions shall be regarded as having been made at the end of the preceding year, except in the case of the taxpayer's first taxable year under the sub-chapter. Applying this rule to the determination of base period capital in the case of the taxpayer which regularly makes distributions in the first 60 days of the taxable year results in an additional capital addition for the year 1949, because base period capital is reduced by such distributions at the end of 1947 and 1948, but is not so reduced at the end of 1949.

Under the Excess Profits Tax Act of 1950 a decrease in inadmissible assets during the last 2 years of the base period in itself constituted a capital addition. However, a decrease in inadmissibles in the excess profits tax years did not in itself constitute a capital addition. This inequity was corrected in the Revenue Act of 1951 by permitting a decrease in inadmissible assets after the end of the base period to be treated as a net capital addition to the extent that such decrease was represented by an increase in "operating assets".

Section 436—Invested Capital Credit

This section states in general terms the rules for determining asset ap-

proach invested capital for a domestic and foreign corporation. A foreign corporation computing invested capital under the asset approach must use only the United States assets and liabilities and may include only borrowed capital relating to those liabilities.

Section 437—Asset Approach Invested Capital

This section sets forth the rates of return which are allowed on invested capital, and sets forth the elements which make up asset approach invested capital. In addition, the section permits the taxpayer to elect in its return for the taxable year to compute its invested capital by the historical approach prescribed in Section 458.

In arriving at asset approach invested capital, assets are included at their adjusted basis for determining gain on sale or exchange, thus taking into consideration March 1, 1913, appreciation. However, in the case of intangible assets the basis is determined without regard to March 1, 1913, appreciation.

There is some doubt whether prepaid expenses such as commissions on sale of stock, unamortized bond discounts, prepaid insurance and taxes qualify as assets under the asset approach method of invested capital. Where such items are material in amount and asset and historical methods give approximately the same result as to other factors, taxpayers would do well to elect the historical method.

Since the Excess Profits Tax Act did not become law until January 3, 1951, it would seem that corporations which incurred excess profits taxes for 1950 should not include the 1950 tax in liabilities at the close of the 1950 taxable year, because it was not a liability at that date. (See *U. S.* v. *Anderson,* 269 U. S. 422). The taxpayer should be advised, however, that omission of the liability may result in a dispute with the Bureau.

Section 438—New Capital Under Asset Approach

The new capital credit applies only to the asset approach and only when adjusted invested capital is in excess of $5,000,000. Under this section, new capital takes a 12% rate of return instead of the lesser rates applicable to invested capital in excess of $5,000,000. Equity and borrowed capital arising from certain intercorporate transactions are excluded from such new capital.

Section 439—Borrowed Capital

Where all of the corporation's borrowed capital is interest-bearing a short-cut computation will eliminate the need for computations on a daily basis. The interest paid or accrued during the year should be analyzed by interest rates and converted into terms of borrowed capital by dividing the interest expense by the interest rate. This computation is quite simple and is ordinarily accurate.

A corporation may save both income and excess profits taxes by borrowing funds to pay such taxes when they fall due, rather than taking advantage of the right to pay in instalments. The amount of tax due, paid in instalments for the year would not be considered as borrowed capital. However, money obtained on notes to pay the full amount at once is borrowed capital which increases the excess profits credit and, provided the interest rate is low enough, will produce an actual cash saving.

The law requires that for excess profits tax purposes the borrowed capital must be employed in good faith for business uses. It is possible that the Commissioner would use this requirement to attack borrowing of this kind, as being for tax and not for business purposes. However, there is no bar to a corporation paying its taxes promptly with its own cash, and then borrowing the equivalent as working capital for current operations.

Section 440—Inadmissible Assets

Inadmissible assets consist of: (1) stocks of domestic and foreign corporations except stock which is not a capital asset as in the case of stock held by security dealers for sale to customers and (2) state and local obligations and exempt Federal obligation.

Stock held in the treasury of the issuing corporation is an inadmissible asset, (Section 40.440-1(b)) except that if stock is purchased for retirement it is considered to be a distribution on the date of purchase. The invested capital is reduced by the paid-in value or the repurchase price of the treasury stock, whichever is lesser.

The basis of inadmissible assets must be adjusted (scaled-down) for losses availed of during prior consolidated return years, but the scale-down does not have to be charged against accumulated earnings. Thus, the adjustment for losses availed of is beneficial to companies using the historical invested capital approach because, while they do not have to make any charge against accumulated earnings, and thus do not have to reduce their invested capital, they are nevertheless entitled to scale-down the inadmissible assets, and thus reduce the inadmissible asset ratio with a consequent beneficial effect on invested capital.

However, companies using the asset approach do not benefit by adjusting inadmissible assets for losses availed of, because even though the adjustment reduces (i.e., improves) the inadmissible asset ratio it also has the effect of reducing net worth which is basically the asset approach invested capital.

Section 441—Rules for Determining Excess Profits Credit

This section sets forth the rules for determining the credit under Section 435 (income method), Section 437 (asset approach), Section 438 (new capital), and Section 440 (inadmissible assets).

For purposes of determining the amount of property paid in stock, etc. under the asset approach it prescribes use of the unadjusted basis for determining gain (including March 1, 1913 appreciation), except in the case of intangible property where March 1, 1913 values must be disregarded.

In determining whether a distribution to stockholders is out of earnings of a taxable year the earnings are computed without deducting income and excess profits taxes for such year. As you probably know, this is a departure from the general rule. Under the general rule these taxes must be deducted in arriving at earnings of any year. This special rule applies both under asset and historical approach and also in determining the current year capital addition or reduction under the income method.

Under the rules of this section where indebtedness of the taxpayer is canceled or released in exchange for stock or as paid-in surplus or as a contribution to capital the amount paid in is considered equal to the face amount of the obligation. This rule does not apply under the historical approach.

Section 448—Regulated Public Utilities

Regulated public utilities are defined as those deriving 80% or more of their gross income exclusive of dividends and capital gains from certain regulated business. Such corporations are allowed a special alternative excess profits credit if they find it advantageous.

In computing this special credit 100% of the borrowed capital (not 75%) is included in invested capital.

The law provides that the income tax entering into the credit computation shall be the sum of the tax imposed by Section 13, 14, 15 and 141(c), I.R.C. No mention is made in the law of the alternative tax computed under Section 117(c). The regulations, however, include the alternative tax under Section 117(c) in lieu of the tax that otherwise would have been imposed. It may be arguable, therefore, that the

ordinary normal tax and surtax of the corporation should be included in the computation even though a lesser amount is payable under Section 117(c).

Although Section 448 of the law seems to require averaging of capital stock, capital surplus and earned surplus for the year where book figures are used to determine invested capital, the regulations and return form require the taxpayer to use amounts of capital surplus and earned surplus at the beginning of the year. This seems inequitable in the case of a corporation whose books are maintained in accordance with a uniform system of accounts, especially in the case of capital surplus arising from an issue of stock during the year. Under the language of the statute it appears that the taxpayer would be justified in using average figures for both capital surplus and earned surplus.

Section 449—Personal Service Corporations

Although a qualified personal service corporation is given an annual election to be exempt from excess profits tax, the corporation's stockholders are taxed on their proportionate share of its undistributed net income. The exercise of this election to be exempt from excess profits tax does not always result in an over-all tax saving. The corporation is still subject to normal tax and surtax and its stockholders are individually taxed on its undistributed income. Experimental computations should therefore be made before electing to be treated as a personal service corporation.

Section 450—Strategic Minerals

Adjusted excess profits net income of a domestic corporation attributable to mining strategic minerals in the United States is exempt from excess profits tax. Where such mining properties are operated under a lease, income attributable to such property derived by a lessor corporation is considered to be income of a corporation engaged in mining.

Although the regulations provide that apportionment of total adjusted excess profits net income should be made on the basis of excess profits net income attributable to mining, it is possible to construe the wording of the Code differently. Where the taxpayer uses the average earnings credit, the portion of the credit attributable to strategic minerals could conceivably be based on base period experience in the mining of that mineral. This could operate to the taxpayer's benefit if a greater portion of the credit may be assigned to income other than from mining strategic minerals, than would ordinarily be apportioned under the method provided in the regulation.

Section 451—Advertising, etc., Expenditures

In computing its excess profits credit by either the income or invested capital method, the taxpayer is permitted to elect within 6 months after the due date of its first excess profits tax return to capitalize the cost of its advertising and good-will promotion campaigns during the base period to the extent to which under the regulations they are considered as constituting a capital investment.

Because this election requires the payment of additional income taxes and interest thereon which results from the disallowance of such expenses for base period years, because the election is irrevocable, and because the elected item must also be capitalized for income tax purposes in all subsequent years, it is only in unusual cases that such election would be beneficial to the taxpayer.

Section 452—Inconsistent Position

A taxpayer or the Bureau may attempt to treat an item entering into its excess profits credit differently than it was treated in a prior year for income tax purposes. In certain of these cases the law requires adjustment of the prior tax liability as the price to be paid

by the taxpayer or the Bureau for adopting an inconsistent position with respect to the item.

Interest on a decrease must be reported as income in the year in which the excess profits tax relating to the inconsistent position is due. On the other hand interest on an increase must be deducted in such year.

Section 453—Mining, Timber, and Natural Gas Operations

Income from mining, timber, and natural gas operations is exempted for excess profits tax purposes to the extent it represents production in excess of normal output. This exemption is also available to a company engaged in the transportation and sale of natural gas.

Under World War II law the tax court held that in order to be entitled to this exemption with respect to the transportation of natural gas, the taxpayer must also sell natural gas (*Barnes Transportation Company*, 14 T.C. 123).

The use of the date December 31, 1939, with reference to the exclusion of a portion of advance royalties from gross income from the property in Regulations 130 (40.453-2 (j)(3)(v)) is apparently an oversight. Presumably the date should read June 30, 1950. It appears beneficial to the taxpayer to ignore the error.

Section 454—Exempt Corporations

Apparently a regulated investment company may claim exemption from excess profits tax under Section 454(c) without electing to be treated as a regulated investment company for income tax purposes.

Section 455—Instalment Basis on Long-term Contract Taxpayers

Because of scarcities of materials and government restrictions which are likely to cause the volume of instalment business to decrease in excess profits tax years, many taxpayers would be at a disadvantage because of having to pay excess profits tax on income from instalment sales made in pre-excess profits tax years. For this reason such taxpayers are permitted to adopt the accrual method of reporting such income for excess profits tax purposes. Similar relief is granted to corporations reporting income from long-term contracts on the completed contract basis.

The last sentence of Section 455(a) states that "No amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of instalment sales made in taxable years ending before July 1, 1950". It was held that a similar provision in World War II excess profits tax law had no effect on deductions and that bad debts relating to sales made in taxable years prior to the taxpayer's first excess profits tax taxable year were deductible.

Section 456—Abnormalities in Income

Taxpayers who realize income which is abnormal in character and amount and which is attributable to some other year may exclude such abnormal income from their excess profits net income. The income must not only be abnormal, but must also be attributable to another year or years for it to be excluded from excess profits net income.

Section 457—Taxpayers Affected by the Merchants Marine Act

This section provides an alternative tax for a corporation which is required to pay to the Maritime Board an amount of profit, if any, in excess of 10%, of the total price of the contract. Such tentative tax which represents the excess of the regular tax under Section 430 computed on income including any payments made to the Maritime Board over the amount of such payments, may be paid in lieu of the tax computed in the normal way.

Under a literal interpretation of the law the full amount of payments made to the Federal Maritime Board may

be deducted from excess profits tax for the calendar year 1950, even though such a tax is only a prorated portion of a year's tax.

Section 458—Historical Invested Capital

A taxpayer may make an election, irrevocable for a particular year, to use historical invested capital. Although after making this election for the year it may not later revert to the asset method, it may however change to the income method for that year.

While invested capital under the asset approach and historical method is frequently identical in amount there are certain situations where one or the other is preferable. Thus, where the invested capital amounts to more than $5,000,000 the asset approach may be preferable because of the additional return on increases in capital during excess profits tax years.

In general, the historical method is preferable to the asset approach in the following situations:

1. Where percentage or discovery depletion is involved.
2. Where there is a deficit in accumulated earnings which arose prior to December 31, 1939.
3. Where there is an unused net operating loss in the base period which can be used in 1950 and 1951.
4. Where the corporation had a predecessor which had a deficit in accumulated earnings.
5. Where losses had been availed of in prior consolidated returns which may be applied in reduction of inadmissible assets without correspondingly reducing accumulated earnings.

For purposes of historical invested capital in determining whether distributions in prior years have been made out of earnings it seems that such determinations for years prior to 1936 should be made under the law in effect for years prior to 1936. Although section 458(f)(3) states that such determination is to be made at the close of the taxable year, this section also states that this rule is only applicable for the purposes of sub-sections (d)(3)(B) and (e)(2) neither of which refers to distributions prior to the taxable year.

Under World War II law the Tax Court held that accumulated earnings and profits must be reduced retroactively on account of contested deficiencies in income and excess profits taxes. (*Stern Bros. & Co.*, 16 T.C. No. 40). Conversely in another case (*Harmon Coal Corporation*, 6 T.C. No. 98) the Court held that a refund on a Sec. 722 claim does not increase accumulated earnings until the claim is allowed by the government. The application of the latter case may be limited to Sec. 722 cases because one factor which influenced the decision was the fact that relief under Sec. 722 could not be claimed in the return filed but had to be applied for in a claim for refund.

Part II

Part II of the Excess Profits Tax Act Law which consists of Sections 461 to 465 allows a corporation which acquired properties in certain tax-free transactions to combine its own base period experience under the income method with that of the transferor of the properties. This part compares with Supplement A under World War II Law.

Section 461—Acquiring and Component Corporations

This section sets forth the transactions which qualify under Part II. These consist principally of tax-free liquidations, transfers to controlled corporations, statutory mergers and other transactions falling within the tax-free reorganization provisions.

Although an acquiring corporation is not required to compute its credit under Part II it is mandatory that a component corporation apply the rules under Part II. Thus, a corporation that transfers some or all of its assets

to another corporation in a Part II transaction automatically loses a part of its base period experience, as a result of the transfer, and this is so whether or not it elects to use Part II and whether or not the acquiring corporation elects to use Part II. Any corporation, therefore, planning to organize a subsidiary should beware of losing part of its base period experience if the subsidiary is unable to use it to good advantage. An exception to this rule is where only cash is transferred to the subsidiary.

Section 462—Average Base Period Net Income under Part II

In computing its average base period net income under Part II an acquiring corporation may use the general average method, the alternative method for growth corporations, or the relief provisions if it qualifies.

Section 462(a) states that if the acquiring corporation computes its average base period net income under the relief Sections 442(d), 443, 444, 445 and 446, the average base period net income after a Part II transaction shall be computed as determined under Part II. Therefore, an acquiring corporation that qualifies under one of the relief sections (except 442(c)) must compute its average base period net income under Part II or abandon the relief.

Section 462 also contains rules to prevent duplication where an acquiring corporation acquires the stock of a component corporation in a taxable transaction. For example if a corporation acquired the stock of another company for $1,000,000 cash in 1949 and then acquired that corporation's assets in a tax-free liquidation in 1950, the acquiring corporation's base period experience would reflect the earnings from the $1,000,000 cash, and were it not for Section 462(j) it would also include the earnings of the component corporation which it acquired for this same $1,000,000.

Section 463—Post Base Period Capital Changes under Part II

This section sets forth the rules for combining the post base period capital addition of component and acquiring corporations where the Part II transaction has taken place after the close of the base period.

Section 464—Base Period Capital Additions under Part II

Where the Part II transaction took place after the first half of the base period, this section contains the rules for determining the combined base period capital additions of the acquiring corporation and its component corporation.

Section 465—Foreign Corporations in Part II

Under this section no foreign corporation can qualify under Part II as either an acquiring corporation or a component corporation.

Part III

Section 470—Asset Approach Intercorporate Liquidations

This section and also Section 472 relate to intercorporate liquidation under the invested capital method. Section 470 pertains to intercorporate liquidations under the asset approach or income method, while Section 472 refers to liquidations in relation to historical invested capital.

In general a "intercorporate liquidation" refers to the receipt of property by one corporation in complete liquidation of another in a transaction where no gain or loss is realized. These transactions would include liquidations under Section 112(b)(6), statutory mergers, and liquidations during consolidated return periods.

The general purpose of the intercorporate liquidation provisions is to adjust the invested capital of the transferee for the difference between the basis of the stock and the basis of the assets received therefor in the liquida-

tion. The theory of this adjustment is to place the transferee in the same position as if it had acquired the transferor's assets directly instead of through the intermediate liquidation of the stock investment.

It should be noted that Section 470 is also applicable to the credit determined under the income method, for purposes of determining base period and post-base period capital additions. Thus, where there has been an intercorporate liquidation with respect to cost basis stock during the last two years of the base period or at any time after the base period, a taxpayer will receive a capital addition for the positive goodwill acquired in the intercorporate liquidation.

Section 471—Non-taxable Exchanges

Section 471 provides the rules for determining historical invested capital where property was at any time paid in for stock, as paid-in surplus or as a contribution to capital in a transaction where the basis in the hands of the transferee is determined by reference to the basis in the hands of the transferor. In such a case the amount paid-in is equivalent to the transferor's basis of the properties minus:

1. The amount of any liability of the transferor assumed by the transferee in the transaction and any liability to which the property transferred was subject; and minus
2. The amount of any original liability of the transferee constituting consideration for the property transferred to it; and also minus
3. The amount of money and the fair market value of any other property (other than stocks of the transferee) transferred to the transferor.

If the result is a positive amount, such result represents the amount paid-in for stock. If it is a minus amount, the amount constitutes a reduction of invested capital.

Section 472—Historical Approach Intercorporate Liquidations

The adjustments for intercorporate liquidations under the historical approach are, like those under the asset approach, based on substitution of the transferee's cost basis of the stock for the transferor's basis of assets. In addition, however, Section 472 provides for a plus or minus adjustment representing the increase or decrease in the transferor's net worth between acquisition of control and liquidation.

The adjustments under this section differ where the basis of the stock of the transferor is a cost basis or non-cost basis in the hands of the transferee. The rules for determining whether stock has a cost basis or non-cost basis are set forth in detail in the regulations. In general terms the purpose of this section is to place the transferee in the same position with respect to cost basis stock as if it had directly acquired the assets of the transferor in a taxable transaction; in the case of non-cost basis stock as if it had directly acquired the assets of the transferor in a tax-free transaction.

A liquidation in connection with a reorganization apparently does not constitute a "intercorporate liquidation" under Section 472. The Board of Tax Appeals in *San Joaquin Fruit and Investment Company,* (28 B.T.A. 395) indicated that a liquidation in connection with a reorganization is not a liquidation at all, but merely one of the steps in a reorganization.

Part IV

The Revenue Act of 1951 added Section 474 to the Excess Profits Tax Law. This section might be referred to as the taxable transaction counterpart of Part II. It is designed to permit a purchasing corporation which has acquired a predecessor's business by purchase or in a taxable exchange to include the experience of the predecessor business with its own base period experience in computing its excess profits credit under the income method.

Wage Freeze Revisions Demand Action

By HERBERT S. MINOT *and* LOUIS ZASLOFF

This useful and informative paper will help CPA's to understand the problems and pitfalls of the national wage and salary stabilization program. Particularly timely is the authors' discussion of the subjects of "Bonus and Fringe Payments" and "Individual and Group Adjustments."

Introduction

THE national wage and salary stabilization program has emerged from its swaddling clothes and is now at the adolescent stage with attendant growing pains.

The stabilization program was inaugurated by federal law, effective January 25th, 1951. All wage and salary personnel were frozen at the rates and levels maintained on such date, until the promulgation of subsequent orders and regulations to advise the general public of the methods by which wage and salary changes could be effected and approved. Numerous such wage and salary orders and regulations soon poured forth from the initiators of the program.

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Mr. Minot, a member of the faculty of Pace College, was formerly attached to the National War Labor Board and affiliated agencies during the last war. Both have served as special counsel to numerous trade associations on industry-wide problems.

During World War II, they were engaged as general and special counsel under the stabilization program in behalf of corporations and industrial groups.

Since there was no such critical emergency as a Pearl Harbor, the general public could only be inducted into the wage and salary freeze by sugar coating this unsavory pill, and by small dose feeding. The public, in blissfully accepting this program, did not anticipate that the second stage would be a little more painful than the first step.

Recently at an American Management Association conference Gordon W. Hostedter, Chief of the Salary Stabilization Board, Compliance and Litigation Division, indicated that a rigid policy of enforcement will be immediately initiated.

The foregoing pronouncement was one of a series of such blunt cautions indicated by each of the enforcement heads of the O.P.S. and the W.S.B.

The authors, at the outset of this program, recognized the symptoms and anticipated the inevitable employer violations which arise out of ignorance and inertia under a wage and salary freeze program. In an effort adequately to apprise the CPA of his duties and responsibilities to his clients, they prepared an article which was contained in *The New York Certified Public Accountant*, March, 1951, issue, entitled "The Certified Public Accountant's Problems Under Price and Wage Stabilization." In this article, an attempt was made to prepare the Certified Public Accountant (who is vitally concerned with the problems of stabilization) by considering in such article, historically and analytically, the resulting problems and pitfalls facing his clients before the end of the current year.

Due to the increased pressure result-

ing from new regulations, new interpretations and new modifications since the summer of 1951, the stabilization program is now getting "hot." Since the CPA is the first soldier on the firing line with the employer, it now appears necessary to sound the alarm for action, to meet current requirements. This sequel then, is designed to bring our original prognosis more emphatically into line with all current regulations, interpretations and modifications.

Indeed, all of the principles and policies stressed in the March article, have actually come to pass. The slight modifications which were made by the Government are so incidental as to provide no concealment from the fundamental principles that were originally set forth. The basic changes which we shall attempt to clarify relate, on the whole, only to procedures and methods.

This article then is intended to bring to the reader, a succinctly stated analysis of the present situation, and how it affects the CPA in his relationship with his clients.

Purpose

The public's inattention to the stabilization program is widespread and may become the basis of serious injury to the CPA and his client. This serious situation is not wholly the fault of the CPA, or the public. It stems rather from the Government's timing of the entire program. In an effort to have the public accept the program without great objection, the Government has moved slowly and ponderously and has made no real effort to educate the public or even supply sufficient explanatory data. The businessman's passive attitude resulting from these policies has increased the burden of the CPA.

Previously, due to a lack of specific forms and a lack of subdivision of the respective authorities under the program, there was considerable confusion and difficulty in presenting applications and obtaining rulings thereon. We now know where and how applications for relief are to be prepared, filed, argued and rulings obtained. Now we are more adequately advised of the nature of our problem and have the answers to the following questions: Under what circumstances does the Government propose to afford relief? Under what regulations is relief afforded? What is the actual method of relief?*

Unfortunately, the Government has failed to disseminate sufficient instructional material concerning the various regulations so as to ease the method of making applications where and when they are necessary.

The Government in an effort to simplify a very complex situation has issued various regulations which experience proved needed modifications and, unfortunately, subsequently needed interpretations. At this point, then, unless the practitioner adequately fortifies himself by reading all of the new regulations, their new modifications and their new interpretations, the answer which he believes he has previously found to his problem may prove to be inadequate.

All of the new regulations may be separated into three general classifications according to the problem covered:

1. Bonus and fringe payments.
2. Individual and group adjustments.
3. Establishment of new business or branch plant.

Bonus and Fringe Payments

Due to the calendar year fiscal closing of most business organizations, and

* *Elimination of inter-plant inequalities and inequities on October 18, 1951:* The Wage Stabilization Board promulgated a new regulation granting increases to workers whose pay was out of line with similar workers in the same or similar industry in their particular area. These adjustments are to be known as adjustments to eliminate inter-plant inequities and must not be used as the basis for unstabilizing intra-plant wage relationships.

the practice of such organizations to pay a year-end bonus to most of their employees above the usual rank and file levels, it is urgent to detail adequately the restrictions and requirements of the stabilization program. In this regard, time is definitely of the essence.

Fringe Issues, i.e., rest periods with pay, vacations with pay, sick leave with pay, etc., are dealt with under all regulations on a basis that such allowances may be made provided the same were actually in existence prior to January 25th, 1951. In the event any modification of the pre-existing situation is contemplated, then an application must be prepared and filed with the Board for approval before it may be made effective.

Bonus Problems. The crux of the current problem is the bonus situation. Generally, all employees are subdivided into those under the jurisdiction of the Wage Stabilization Board and those under the jurisdiction of the Salary Stabilization Board. The line of demarcation is the following:

1. All employees who are not of executive or administrative capacity, and who meet the criteria of the Fair Labor Standards Act (popularly known as the Wage and Hour Law) fall within the WSB.

2. All exempt employees under this Act with executive or administrative capacities fall within the SSB. The establishment of the jurisdiction of an employee or group is of first importance as there are different rules applicable to each class.

Bonuses under WSB Rules

G.W.R. 14 sets forth the various rules under which bonuses may be paid. It segregates those companies which have a formal plan from those companies which do not.

1. No application is required where a company in either group seeks to pay an employee, or group of employees, or all employees, a bonus of percentage or amount equal to that paid prior to freeze date.

2. A post-review application is required to be filed with the Wage and Hour Division within three months following the effective date of GWR 14 where an organization under an established plan seeks to pay a bonus to an individual employee in any bonus year of 25% or more of his total wages, salaries or other compensation, excluding bonus in any such year or period.

3. A prior application for approval must be made by organizations who have no formal plan, and where the total amount or percentage of bonus to be given to any employee or his successor in any bonus year, exceeds the amount or percentage of bonus paid to the employee during the preceding bonus year; if the same exceeds by 25% or more his total wages, salaries or other compensation, excluding bonuses of any such year.

4. Permission is granted without application to an organization without a formal plan to vary the amount of bonus paid to individual employees in any group, provided the total of the group does not exceed the total of the base year prior to the freeze date. No employee, however, may exceed the 25% rule previously stated; and no employee may be paid a greater amount than the highest amount paid in the base period to any employee.

5. An application must be made to the Board for approval where any variation is sought under a formal plan or where any variation is sought which is contrary to the above rules.

Bonuses under SSB Rules

The bonus rules for executives and administrators under the jurisdiction of the SSB are in many ways different from those for rank and file employees.

1. There is no 25% limitation upon the dollar amount to be paid for a bonus.

2. There are two alternative base periods which the employer may take into consideration.

The SSB regulations prohibit a payment in excess of the dollar amount

received by the executive during the base period or received by an executive of a group which is higher than the highest paid to an executive of such group. The bonus paid to the group is called under the regulations a "base period bonus fund." If the employer proposes to pay more to any one executive of a group, then he must decrease by such dollar amount other executives within the group, so that at no time does his total dollar amount bonus payment exceed the total dollar amount paid to the group during the base period he has selected. If an employer intends to pay more than is hereinabove outlined, then an application to the SSB is required, and no payment may be made until approval is obtained in writing.

The alternative base periods provided are as follows:

1. The employer may take the average of any three consecutive years within the five calendar years, 1946-1950, or

2. The last fiscal or calendar year of the employer prior to January 25, 1951.

Contractual Bonuses. An exception is created by the regulations insofar as the same relates to a "contractual bonus." Such bonuses in effect on or before January 25th, 1951, may be continued for future periods. These arrangements are commonly found in corporate documents, legal contracts or corporate minutes. In all other respects, it should be borne in mind that no bonus may be paid to an employee which is contrary to the bonus history of the company as existed on January 25th, 1951.

Increments to Existing Bonus. In any situation wherein an employer intends to pay in excess of an established formal bonus plan, or, in excess of the bonus history of any employee, such situation must be the subject of an application to the SSB, and may not be paid until approved.

Record Keeping. The regulations further require every employer to keep records sufficient to establish compliance with GSSR 2. Such records must be maintained for three years following the year within which a bonus payment is made.

Discretionary Payments Within Bonus Fund. Where bonuses are paid on a discretionary basis, a report setting forth the pertinent facts, including the amount and the basis of the increase, must be filed with the SSB within 30 days after the payment or the allocation from the bonus fund has been made. (Post Review Application.)

Individual and Group Adjustments

Generally, business organizations fit within three categories for stabilization purposes.

1. *Formal Plan,* i.e., those companies which have always maintained a formal written plan of wage and salary administration fully communicated to all employees. Where such formal plan in writing meets the other criteria set forth in GWR 5, then any and all contemplated individual or group adjustments, within the confines of the formal plan, may be made without the further approval of the Stabilization Board.

2. *Informal Plan,* i.e., those companies which have maintained wage and salary administration by an informal plan, or a plan not in writing and not communicated to its employees. Adjustments may likewise be made to the individual or group provided the adjustments are kept within the confines of the informal plan, if the same be found in the payroll records and personnel data of the company for the 12 month period prior to January 25, 1951.

3. *No Plan,* i.e., those companies which have maintained no formal or informal plan for wage and salary administration, but historically made adjustments to individuals and groups spasmodically in order to meet whatever current pressures were exerted.

Such companies are strictly confined to adjustments which do not exceed the highest paid to any employee of the same calibre or job content classification. All other situations must be submitted by application for approval by the Board.

Regardless of the category in which a company falls, each company may be faced with many types of adjustments, each requiring different research, problem analysis and processing.

1. *Merit and Length of Service.* Adjustments for individual employees which are wholly based on merit and/or length of service have been described above and should be treated accordingly.

2. *Promotions and Transfers.* Adjustments for individual employees which are based upon promotions and transfers are treated on the same basis as merit and length of service adjustments. However, the basis and justification for such adjustments would have to fit the circumstances of each case.

3. *Reclassification.* Adjustments for individual employees based on reclassification to new or changed jobs likewise may be treated in the same nature as merit and length of service adjustments.

4. *Payments Below and Above Minimum Rate Ranges.* Payments below the minimum of a rate range may not be made unless under a formal plan which meets the criteria of G.W.R. 5. All other situations require approval. Payment to any employee above the minimum of the rate range must be justified in such fashion as to clearly indicate a basis for a payment higher than the minimum. Here no application is required.

5. *Inter- and Intra-Plant Inequities.* Any increases on the basis of inter- or intra-plant inequities must be submitted for approval to the Board.

6. *"Across the Board".* All general increases "across the board" to an entire plant or group or pursuant to a collective bargaining agreement must be submitted to the Board for approval. Such adjustments must be measured by the Board against the cost of living adjustments permitted under GWR 6 which now stands at approximately 12.02%.

7. *Cost of Living-G.W.R.6.* Cost of living adjustments to the individual, the group, or the entire plant, are permitted whether with a plan, formal or informal, or none; provided the employer files a report known as G.W.R. 6a, giving the Government all required information under the regulation. The adjustment stands approved unless within ten days from date of filing, the Government notifies the applicant that it has been disapproved.

8. *Tandem Adjustments,* as described in the regulations, refer to the maintenance of the historical differentials in pay between employees in a group and their supervisory personnel. The best illustration of this type of adjustment is found in the situation wherein a collective bargaining agreement proposes a 10¢ per hour increase to all production employees, thereby upsetting the historical differential between such employees and their supervisory staff. This circumstance is treated as a tandem adjustment and the employer, provided the general adjustment for the production workers has been approved or is within the regulations of the WSB, may obtain approval to grant to all supervisory employees adjustments of the same ratio difference, in order to preserve the historical differential. Application should be made to the appropriate Board according to class of employees involved.

Maximum Benefits Possible Under a Formal Plan

The authors, in their experience, have found that many organizations which believed that they had a wage and salary situation reduced to a formal plan in writing have been rudely

awakened to the realization that it does not conform to the criteria set down by GWR 5. This situation can be corrected at this time. The formal plan which is in writing must have the following elements:

a. A complete list of all job titles; labor grades, if any, under job classifications.

b. A complete description for each such labor grade or job classification.

c. A minimum and maximum rate range for each such labor grade and job classification.

d. A standard practice and procedure for granting adjustments for merit, length of service, hiring, promotion, probation, reclassification, transfer, fringes and bonuses.

All of the foregoing must be actually in writing, actually communicated to the employees, and actually in existence on or before January 25th, 1951.

To establish further its rights to operate pursuant to this plan, the company meeting all of these criteria, should submit it to the Board and receive a ruling in writing. Subsequent to such ruling, it must consistently and accurately maintain in record form the actual administration of its plan.

Any modification, alteration or amendment of an approved formal plan must be cleared by a filing with the Board.

Those organizations which may have had an informal plan, or no plan whatsoever, may now formalize their plans. A new regulation has been promulgated by the Government ammending G.W.R. 5 to permit all companies which meet the criteria set forth above to establish a formal plan of wage and salary administration *de novo*. Where a company avails itself of this privilege, it immediately attaches to itself:

1. the right to grant various adjustments to its personnel without further application to the Board;

2. the secure knowledge that such adjustments are proper and lawful under the regulations; and

3. a form of protection in the sense that such adjustments will not result in penalties for non-compliance.

The privilege given to every business organization to create a plan in writing to formalize its current wage and salary practices, and to obtain a blanket ruling that it is in compliance with G.W.R. 5 is deemed by the authors an undisguised blessing to the employer.

Specific Advantages:

1. The employer by qualifying now puts his wage and salary administration on the same basis as that maintained by the large corporations for the past many years.

2. He attains sufficient flexibility to solve the greatest number of daily problems.

3. It grants to the employer a lawful measure of discretion within the scope of his plan.

4. It gives the employer a permanent and long-range benefit in standardizing his various departments, groups and categories of personnel.

5. It aids immeasurably in simplifying the issues which are presented in discussions of a union agreement.

6. The employees are pyschologically lifted by the feeling that all within the same group are accorded equal treatment.

7. It cements friendlier feelings with the union, as it displays a progressive attitude towards labor on the part of the employer.

It may readily be seen from all of the foregoing discussion that the establishment and approval of a "new formal plan in writing" is a boon to the employer and his employees.

The New SSB 6%—10% Option and the New WSB 6%—10%—5% Option

Both the Wage Stabilization Board and the Salary Stabilization Board

have promulgated amendments to their original GWR 5 and the adopted amendment GWR 5 of the SSB. Both set forth new maximum limitations where adjustments are granted in relation to merit and length of service.

SSB New 6% and 10% Option

The SSB, in adopting the standard practice and procedures of the WSB as was set forth in GWR 5, modified the ability of the employer to grant indiscriminate adjustments whether with or without a formal plan. In effect, the new SSB regulation states plainly that no employer may make adjustments for merit and length of service in excess of 6% of the total of the base salaries during the previous base year. Further, no individual employee may be granted an adjustment for merit and length of service in excess of 10% of his base salary in the base year, even though there be further permissible room within the 6% over-all budget.

How Calculated

In order to arrive at the budget of 6%, you are required to total the straight time rates for the payroll period ending nearest January 15th of the current calendar year. This 6% figure is the total of merit and length of service increases combined that may be granted in the current calendar year.

WSB New 6%—10%—5% Option

Only where establishments have an informal or no plan, but do maintain what is termed "Personal or Random Rates" is the 6% option applied. It does not apply to companies that have a formal plan.

How Calculated

In order to arrive at the budget of 6% you must take 6% of the total of the average straight-time earnings of your employees in the fiscal or calendar year prior to January 25th, 1951.

10% Limitation

Under no circumstances may you grant to any one employee more than 10% of his salary as a merit or length of service increase within your budgetary figure.

5% Limitation

Under no circumstances may you increase above 5% any employee who is at the top of the group of the personal or random rates.

It should be borne in mind that both the 10% and 5% limitations described above are individual adjustment ceilings, whereas the 6% is a budget limitation covering amounts that can be distributed to your employees.

The Government Plugs a Loophole

The establishment of artificial maximums of rate ranges, i.e., those not actually paid, has now been precluded where such increases in the maximum of a range amount to more than 15% above the highest rate actually paid in the 6 months period prior to the freeze date. In all events, any increases in rate ranges should be filed for this period with the nearest office of the appropriate Board. The problem arises where the employer seeks to make payment to his employees of an increase after the freeze date, based on the artificial maximum which he claims to have established prior to the freeze date.

Any company which has "jumped the gun" by revising any of its existing rate ranges between June 24, 1950, and January 25, 1951, must disclose all such revisions by actually filing all pertinent information within 60 days from the date of the amendment to GWR 5. It appears that the failure to disclose by a post-review application may invalidate adjustments in reliance on such self-created maximums.

Violation Penalties

The penalties for violations of the wage and salary stabilization program are undoubtedly familiar to every CPA since they are virtually the same penalties which were in effect during World War II covering an almost identical

program. Familiar as they are to the CPA, the ignorance of the average employer-client makes it imperative that every CPA point up forcefully these penalties and their consequences:

1. Disallowance of unlawful wage and salary adjustments for tax purposes not only for the excessive amount but for the total amount of the wage and salary payments.

2. Loss of Government priorities on materials in connection with public and other contracts.

3. In severe cases, criminal prosecution by the United States Attorney's office.

The above is the negative aspect of the problem. A positive aspect is for each CPA to stimulate his client:

1. To set up schedules, practices and procedures to constitute a *formal plan* which is accorded most favored treatment under the existing regulations and in addition,

2. To assist his client in preparing a *comprehensive labor audit,* which not alone reflects all phases of personnel conditions in the company, but also surveys comparable companies in the area.

The country is rapidly approaching a period when labor piracy may be rampant as during World War II. While all adjustments contemplated under the stabilization program today are voluntary adjustments, the employer must be cautioned to review his minimum and maximum rates and ranges, and fringe items, so as to avoid the loss of *key personnel* and *essential workers.*

Conclusion

What then is the status of the CPA with reference to the stabilization program?

1. He must meet the problem head-on by awakening his clients to the dangers of the situation.

2. He must familiarize himself with the entire program, and determine in what respects his clients are affected.

3. He must help his clients and their counsel, in every proper way, to solve their problems in this area.

AN ADIRONDACK VIEW

Christmas Presents. Do they bother you? Those you receive as well as those you give? Various publications try to help, including *Fortune,* which had a 30 page Business Gift Section in 1950 and a 27 page section in 1951.

An analysis of the 1951 section is probably a certain clue to what you will get this year, so be prepared! Liquor 35%, food 7% and things 63%. So, for every six gadgets you get this year, you can expect only one box of nourishment to sustain you in their use but you will have three bottles of fortification to keep you in good humor.

Well, perhaps this "scientific" study of what you will get is distorted by hidden factors; but we hope the holiday is a merry one for you and your family; and we know that the men CPA's will get few adding machines which they can use—and plenty of neckties which they won't dare to use.

LEONARD HOUGHTON, CPA
Adirondack "Chapter."

Price Regulations in the Retail Trade

By Kenneth P. Mages, C.P.A.

This article reviews the regulations applying to department and specialty stores on a broad basis. In it the author discusses the following ceiling price regulations as those most likely to affect them: CPR 7—General Consumer Goods; CPR 11—Restaurants; CPR 15 & 16—Certain Foods at Retail; CPR 31—Imports; CPR 34—Services; and CPR 45—Apparel Manufacturers.

Price regulations in the retail field are not the subject of as much discussion today as they were during the early part of this year following the issuance of the first few orders which affected department and specialty stores. While in other fields, particularly in manufacturing where industry orders continue to be issued, the interest in price regulations is very keen, in retailing the stores are operating with regulations which for the most part they understand quite well. Because of this, it appears proper in this talk to review the regulations affecting department and specialty stores on a rather broad basis.

Title IV of the Defense Production Act gave to the President a variety of powers, one of which is the authority to control prices. The President, in turn, delegated the price control powers to the Economic Stabilization Administrator, who is Mr. Eric Johnson. By another delegation of power, the ceiling price operations were vested in the Office of Price Stabilization, which is responsible to the Economic Stabilization Administration, and whose Director is Mr. Michael V. DiSalle. On an over-all basis the Economic Stabilization Administration, the National Production Authority and other agencies report to the Office of Defense Mobilization which, under Mr. Charles E. Wilson, functions as a policy-making authority.

The Office of Price Stabilization is divided into eight commodity sections as follows:

1. Food and restaurant.
2. Rubber, chemicals and drugs.
3. Industrial materials and manufactured goods.
4. Consumer durable goods.
5. Forest products.
6. Consumer soft goods.
7. Transportation, public utilities and fuel.
8. Services, exports and imports.

By law, certain items are exempt from price control. These include rents, professional fees, publication and advertising rates, insurance rates, rates charged by common carriers and other public utilities, and margin requirements on the security exchanges. Some of the exempt items, however, are controlled in other ways. In addition, the Office of Price Stabilization may exempt items from price control by regulation.

General Ceiling Price Regulation

The General Ceiling Price Regulation became effective on January 26, 1951, and established a ceiling price for all commodities and services except those which were specifically exempt in the order. The base period under the order was the period from December 19, 1950, to January 25, 1951, and the ceiling price generally was the high-

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This paper was presented by Mr. Mages at the regular monthly meeting of the Society, held on October 22, 1951, at the Hotel Roosevelt in New York City.

est price at which commodities were sold or offered for sale during that period. Following the issuance of the General Ceiling Price Regulation, a wide variety of regulations and orders were issued so that as of October 15, 1951, there were approximately 137 regulations to which have been added about 130 supplements. In addition, in connection with one of the regulations, namely CPR 7, about which we will see more later, more than 700 special orders had been issued. The 137 regulations include 6 general orders, 22 delegations of authority, 9 procedural regulations, 79 specific ceiling price regulations for certain commodities or industries, and 18 overriding regulations.

It is not possible because of the differing merchandise coverage among various department and specialty stores to spell out exactly the ceiling price regulations with which such stores would be concerned. However, the following group of regulations are those which most generally affect them:

CPR 7 —General consumer goods.
CPR 11 —Restaurants.
CPR 15, CPR 16 —Certain foods at retail.
CPR 31 —Imports.
CPR 34 —Services.
CPR 45 —Apparel manufacturers.

CPR 7, which is probably the most elaborate of these regulations, covers the bulk of department and specialty store merchandise.

CPR 7—General Consumer Goods

CPR 7 became effective on February 27, 1951, and provides for the preparation of a series of charts for each department of a store. The regulation, as presently amended, covers approximately 220 categories of merchandise and each department in practice will have as many charts as it has categories of merchandise. The same category of merchandise may appear in more than one department. On the list date, which was February 24, 1951, for most categories, stores were required to list in one column of a chart each different unit cost (less cash discount and excluding transportation and handling costs) once, and to indicate opposite this unit cost the initial offering price. Where a cost price had more than one initial offering price because it may have represented several different items, the cost price was to be repeated and each of the several initial offering prices were shown opposite it. A category mark-up per cent was computed using the sum of all the cost and retail prices on the chart. Likewise, the mark-up percentage for each single cost and retail price was shown. In those cases where several retail prices were shown opposite a series of identical cost prices, the retail price on the line which had a mark-up percentage which came closest to the category mark-up percentage was circled and in future pricing only that retail price is used for items with that cost.

CPR 7 spells out 8 rules to be used by the stores in pricing merchandise represented by the charts described above. Where a new item has a cost corresponding to that on the chart, the corresponding retail is the ceiling price. If the cost is lower than the lowest cost on the chart, a mark-up percentage which is the average of the two lowest items on the chart is used. If the cost is higher than the highest on the chart, then the average mark-up percentage of the two highest on the chart, or the category average, whichever is lower, is used. When a cost falls between 2 entries on the chart, the average of the one above and the one below is used. When new categories are encountered in a department, it is necessary to use a table in the regulation which spells out comparable categories which then are used as the basis of pricing provided the store has charts for such categories. The regulation also provides a means of pricing merchandise where there are no charts for comparable categories by using the average mark-up percentage of three or more categories in a related group of categories and using this average as a means of determining a specific mark-up percentage from a certain table in the regulation. Likewise, where

none of the pricing rules can be made to apply, a special series of mark-up percentages is included in one of the tables which when applied to the cost will produce the ceiling price.

In some categories, such as housewares, notions, sporting goods, silverware, china, glassware and jewelry, the number of items is so voluminous that small-volume retailers would have been confronted with a great burden in attempting to prepare charts. Accordingly, where the volume in these specific categories in the aggregate was less than $60,000, or where the total sales of stores dealing mainly in such categories was less than $100,000, an election to price under the General Ceiling Price Regulation was permitted. A similar choice was permissible if the sales in categories other than those mentioned above were less than $20,000. At the outset, an election to price under the General Ceiling Price Regulation would have been a more difficult decision to make than at present, since there was no provision for taking care of the squeeze which would result if the cost of such items increased. However, supplementary Regulation 29 removes the replacement squeeze which was inherent in the General Ceiling Price Regulation as originally promulgated. It is now permissible to apply a mark-up percentage, based upon the cost closest to May 28, 1951, and the corresponding offering price, to subsequent costs. It shoud be borne in mind in this connection that the use of this device will not only increase ceilings when the cost increases, but will decrease ceilings whenever there is a reduction in invoice cost.

To allow manufacturers to follow their existing practices of controlling retail prices, the OPS upon request will issue orders providing for uniform dollar and cents ceilings on such branded merchandise. In excess of 700 such orders have been issued to date.

CPR 11—Restaurants

The restaurant order, CPR 11, became effective on April 1, 1951. Since that date retail prices have been controlled in a somewhat indirect manner, since the order revolves around the food-cost ratio, that is the ratio of the cost of food to sales. The base period for the restaurant order is the calendar year 1949 or the 12 months ended June 30, 1950. During each 4-month period (or 16-week period) starting on April 1, 1951, a restaurant is expected to maintain the same food-cost ratio that existed during the corresponding 4 months of the base period. It is permissible to use monthly ratios for comparisons although the reports to the OPS are still to be on a 4-month period basis. If at the end of any 4-month period the food cost ratio is lower than what it was during the corresponding 4-month period of the base year, the restaurant is expected to adjust its prices (or its food portions or quality) so that by the end of the second 4-month period the food-cost ratio for the entire 8 months is in line with the base period. It can readily be seen that if a restaurant is out of line during a 4-month period the adjustment in the next 4-month period must be severe enough to compensate for the previous period as well as to keep the current period in line. A restaurant which did a poor job in controlling food costs during the base period is prevented, except in cases of proven financial hardship, from getting the full benefit of improvements in efficiency which result in a lower food cost, since any reduction in food cost must carry with it a reduction in the prices charged. The regulation also provides for service or minimum charges where this was a past practice, and the segregation of beverage costs from other costs in a combination operation. There are also the usual provisions for new operators, and for exemptions which include hospitals, educational and fraternal organizations, and non-profit clubs.

CPR 15 and 16—Certain Foods at Retail

The control over the sale of foods at retail, primarily dry groceries and perishables, was divided into two regulations. The reason for two regulations

is that the orders provide for specific mark-up percentages to be applied to various items depending upon the size of the store. Therefore, CPR 15 is designed for individual units of chain stores, as defined, with sales of less than $375,000 (Group 3) and for other stores, chain or independent, with sales of more than $375,000 (Group 4). CPR 16 is designed for independents with sales of less than $75,000 (Group 1) and for independents with sales of $75,000 to $375,000. In technique, both regulations are basically the same. In each case it is necessary to arrive at the net cost of each item (cost less trade discounts) to the nearest ½¢ and to determine from a table in the regulation the mark-up per cent applicable to such net cost based upon the sales volume of the store and the type of item, such as cereals, coffee, flour, or frozen foods. The next step is to use another table in the regulation whereby the mark-up per cent just determined and the unit cost computed earlier will lead the store to a dollar and cents ceiling. The regulation first applied to prices in existence just prior to May 14, 1951. Thereafter, on each Monday, based on the most recent costs then in existence, the retailer is allowed to recompute his ceilings in the manner outlined above. CPR 15 and CPR 16 make provision for specific charges to be made for delivery, for telephone orders, for the forwarding of gift boxes, and for other special services. Likewise, provision is made for adjusting prices for special operating conditions, such as the warehousing and storing of frozen foods, or where the distance from the warehouse to the store is more than 125 miles. Furthermore, a store which ordinarily would come under CPR 15 because of its large size, could operate under CPR 16, which deals with smaller stores, if it was a full service store and was competitive with other smaller stores. In such cases it would have to have a 23 per cent gross margin and the choice of operating under CPR 16 would have to be approved by OPS.

Instead of running a typical supermarket operation, most department stores operate a delicatessen-type of food department which has a high initial markon per cent. In these cases if the initial markon per cent has been 40% or more and the store gives this department the usual service which it gives elsewhere in the store, namely free wrapping and packing, free delivery, telephone orders, charge accounts, and other services, then it can apply to the OPS to operate under the General Ceiling Price Regulation, in which case its initial markon could continue more or less at its normal level.

CPR 31—Imports

The import regulation, CPR 31, has been the subject of much controversy and the effective date was repeatedly postponed. It finally became effective on September 1, 1951. CPR 31 covers all imports except certain strategic commodities and certain commodities which are essential to the basic cost of living. In addition, of course, the usual exemptions embodied in the General Ceiling Price Regulation prevail. In retail stores imported items which have been purchased from an importer are controlled by the ceiling prices spelled out in CPR 7, CPR 15 or CPR 16, if these latter regulations identify the specific merchandise by category or commodity. Otherwise such imported items and all items which are direct imports come under CPR 31. Retailers who import their own merchandise determine the ceiling price by applying a base period mark-up per cent to the landed cost of the items in the inventory at the effective date. The landed cost should be based upon the last invoice prior to January 26, 1951, or to the first one after January 6, 1951. The base period mark-up per cent is determined from all of the costs and all of the initial offering prices within a representative quarter of the base period, that is a representative quarter within the year from July 1, 1949, to June 30, 1950. The mark-up percentages can be computed commodity by commodity, by category, by country of origin, or storewide or by department. Once selected, the basis cannot be changed. However,

it is permissible to use a commodity by commodity basis in one department, a category basis in another, and country of origin in a third, and a different base period quarter may be selected for each commodity, category, country of origin, etc.

CPR 34—Services

CPR 34 deals with services generally and while the regulation applies to other services besides those supplied by department and specialty stores, so far as we are concerned it applies to operations which we generally describe as workrooms or alteration rooms. On the whole, the ceilings under CPR 34 are those which were in effect under the general ceiling price regulation. However, CPR 34 provides bases for adjusting the ceiling prices based upon increases in cost, seasonal variations, negotiated prices, and so forth. Such adjustments in prices were necessary because during the base period, that is from December 19, 1950, to January 25, 1951, some services such as fur storage and fur repair were out of season.

CPR 45—Apparel Manufacturers

In some stores the workrooms may do custom tailoring. Such operations come under CPR 45 which sets ceilings for apparel manufacturers. This being a manufacturer's order, it deals in direct material and labor as well as indirect labor and other elements of overhead. It is felt by many stores that a special regulation should be written to cover such operations in department and specialty stores, since typically this does not constitute a large segment of the business and, therefore, the accounting records expected to be found in manufacturing plants are not kept by the stores, thus making compliance with the details of CPR 45 very difficult. The effective date for mandatory pricing under CPR 45 has not been established although it is permissible to price under it.

Current Problems

CPR 7 has two sections which have been especially disturbing to retailers. One of these sections, 30-A, provides that the OPS could grant an increase in a manufacturer's ceiling price which increase is to be labelled separately on the invoice as a "permitted increase." This was done in SR 11 to GCRR which granted a 15% "permitted increase" to manufacturers of floor coverings. By this order the retailer determined a ceiling price by arriving at a unit cost without taking into consideration the permitted increase and added to the ceiling price the exact amount of the permitted increase on a per unit basis. The effect of this is to pass through to the customer the amount of the permitted increase without giving the retailer the markon otherwise provided by his chart. If this practice became widespread, of course, the markon percentages of retailers would be severely depressed, although certain expenses directly relating to sales, such as commissions, would rise. The other section, 31, provides that if an invoice carries a separate item called "OPS adjustment charge," it shall not be used by the retailer in computing unit costs for purposes of determining ceiling price. This could mean that the retailer would be forced to absorb the OPS adjustment charge. In addition, Section 31 provides that "net cost" shall not include transportation costs, although retailers ordinarily would include such items in determining the amount of markon. Thus any increase in transportation costs would have to be absorbed by the merchant. "Cost absorption" accordingly has come to carry great significance in retailing.

The Defense Production Act of 1951 which became law on July 31, 1951, contained two controversial amendments which recently have been the subject of intense discussion in Washington and elsewhere. The Capehart amendment added Section 402(d)(4) which gives a manufacturer, subject to a ceiling price, the right to request an adjustment in it based upon cost increases prior to July 26, 1951. The same section defines costs to be "material, indirect and direct labor, factory, selling, advertising, office and all other

production, distribution, transportation and administration costs, except such as the President may determine to be unreasonable and excessive." The OPS has taken the position that the Capehart amendment makes price control at the manufacturers' level unworkable inasmuch as the allocation to specific products of some of the items defined as cost is impracticable. Senate Bill 2170 would have modified the Capehart amendment by giving more leeway to the OPS and would have provided some rollback of prices to pre-Korea levels, provided certain cost increases to July 26, 1951, were recognized. In effect, S-2170 was described as minimizing or offsetting much of the Capehart amendment. At any rate the Capehart amendment as enacted may put the OPS in a position of granting price increases which it will be tempted to pass on to the consumer as a permitted increase, and thus not give the retailer his customary markon.

However, the Defense Production Act also added Section 402(k), known as the Herlong amendment, likewise a very controversial section, which applies only to OPS orders issued after July 31, 1951, and which requires that retailers and wholesalers be allowed their customary percentage margins over the costs of materials between May 24 and June 24, 1950, except for certain items in short supply. The Herlong amendment would seem to offer considerable protection to retailers from the evils of the "permitted increase" and "cost absorption."

With the adjournment of Congress on October 20th S-2170 regarding the modification of the Capehart amendment and another, Senate Bill 2048, providing for the repeal of the Herlong amendment, will not be passed at this time.

Summary

To summarize, the segment of the retail trade represented by department and specialty stores has passed through the first phase of price stabilization—eight months—and while it has fared quite well in mastering the mechanics of compliance with the regulations, thanks to the considerable amount of experience gained during World War II under the OPA, it has *not* come through unscratched as far as profits are concerned.

Following the publication of the very low department and specialty store profits for the first six months of 1951, there was criticism of the price control program by the retail trade as having been a decisive factor in such low profits because of the virtual freezing of initial markons. The margin type of control, which was accepted by retailers generally, was predicated upon the assumption that a large increase in sales would occur and such increase in sales coupled with reduced markdowns would produce enough gross margin dollars to absorb the rising expense load. Such has not been the case. According to data released by the Controllers Congress of the National Retail Dry Goods Association, 194 reporting department and specialty stores experienced an increase in initial markon of 0.1%, from 38.8% to 38.9%, but likewise had an increase in markdowns and workroom costs so that gross margin dropped 0.2% to 35.3%. Even with an increase of 2% in sales the gross margin dollars were not enough to absorb a full 1.4% increase in expenses. As a result, profit both before and after taxes was less than half of that for the first half of 1950.

A second and perhaps more crucial phase, in my opinion, has now begun. As stores exercise their right to continue rendering services to the public at a fair profit, the OPS is attempting to stem inflation under wage conditions which allow many costs to increase with attendant piercing of manufacturers' price ceilings. Also, the environment which made controls more palatable during World War II has not developed. Barring an expansion of the Korean conflict then, the next year may well witness an intensification of the differences between business and government on the matter of price controls.

Auditing Problems Related to Wage, Price and Other Government Controls

By THOMAS D. FLYNN, C.P.A.

After commenting briefly on the underlying philosophy upon which the regulations are based, the author discusses the auditing problems arising from wage, price and other government controls which are involved in rendering an opinion on financial statements.

MOST of us can agree, I am sure, that wage, price and other government controls have greatly complicated the life of the certified public accountant. In addition to the onerous task of keeping up with City, State and Federal tax laws, SEC regulations, requirements of public utility commissions and other public bodies of long standing, the harried accountant must now plunge into the careful study of a voluminous and formidable mass of regulations issued by the Wage Stabilization Board, the Salary Stabilization Board, Office of Price Stabilization, and to a lesser extent the fairly recent regulations of the Controlled Materials Plan. The future course of these controls is probably uncertain to most of us, but it appears probable that these and similar controls will be with us for some time to come, certainly a minimum of two to three years, even under the most favorable settlement of our differences with the communist world on the international front. It is my guess that controls will become more burdensome in the future. Wage and price controls have not so far seriously cramped either business or labor. Probably credit controls and restrictions on building have had a greater effect. The Controlled Materials Plan is only now getting under way. We can, however, expect that as the rearmament program gets rolling in high gear and its real impact felt these controls will increasingly confine and hamper the normal flow of business. Clamping a lid on inflation can be a painful process.

The businessman is going to be impatient of these restrictions and will seek to do the things which his business judgment tells him should be done. This means that he will require assistance not only from his own personnel but also from his lawyers and accountants.

To provide the necessary assistance and advice to business and to apply intelligently auditing procedures with respect to compliance with government controls, we need a good over-all understanding of the regulations and a working knowledge of the basic regulations. Furthermore, since new regulations are being constantly issued and old ones revised, we must keep informed currently of the latest developments. The best way of keeping abreast of these changes is to subscribe to one of the services such as those published by Commerce Clearing House and Prentice-Hall.

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This paper was presented at a technical meeting of the Society held on September 25, 1951, under the auspices of the Committee on Auditing Procedure.

Philosophy Underlying the Regulations

While a brief summary of the important provisions with respect to wage, price and other government controls might be helpful in providing a background for discussion at the conclusion of this paper, we do not have the time available. However, a few comments with respect to the underlying philosophy on which the regulations are based will perhaps serve instead. As you all know, prices were frozen as of January 25, 1951. As required by the Defense Production Act of 1950 salaries and wages had to be stabilized at the same time in the same businesses and industries. It was recognized that in general if wages go up, prices must also go up. Accordingly, the general wage stabilization regulation was made effective at the same time, that is, on January 25, 1951. Freezing prices and wages at some arbitrary date in a dynamic economic society will almost invariably produce inequities. Basically WSB recognized two kinds of inequities. The first inequity relates to the increase in the price level during 1950. Wage adjustments to reflect the increase in the cost of living were not uniformly made throughout our economy during this period. In order to provide in some measure for a correction of this maladjustment, Regulation 6 was issued by WSB which permitted adjustments without its approval up to 10% of the wage level prevailing on January 15, 1950. Cost of living adjustments actually made since that base date were, of course, to be charged against the allowable 10% increase. I need not remind you that the selection of the exact amount of this percentage was the subject of serious disagreement between the labor members and other members of WSB.

The second inequity recognized by WSB as arising from the freeze on wages at a given date relates to the individual wage adjustments which business must make from time to time to correct inequities *within* its own organization. These adjustments include merit and length of service increases, promotions, transfers, hiring of new employees and creation of new jobs. WSB believes that "these housekeeping adjustments, when properly made, do not normally increase labor costs." WSB therefore permits an employer to follow with certain limitations his 1950 experience in making these adjustments.

Price regulations are based upon a similar philosophy. Having frozen prices at their highest level during the five weeks ended January 25, 1951, OPS recognized that not all businesses had increased prices on the same relative scale during 1950, and particularly since the outbreak of the Korean War in May 1950. In order to permit some flexibility in the price structure, OPS issued a whole series of regulations designed to permit price increases to the extent wage and material costs had risen more rapidly than prices in a given business or trade.

Auditing Problems Involved

What are the auditing problems arising from wage, price and other government controls which are involved in rendering an opinion on financial statements? As I see it, our main auditing problem is to determine that a business is not subject to substantial penalties for violation of the regulations issued by the various government control agencies. Our task in this respect will be much easier if we are called in to assist our clients during the year in compiling and preparing data for use in connection with wage and price stabilization. In such cases we will ordinarily need comparatively little investigation at year-end to know whether or not our clients have complied sufficiently with the various government control regulations. In any event our auditing procedures, both during an interim period and at year-end, should be sufficiently comprehensive that severe violations are brought to our attention, since the

contingent liability arising from possible assessment of penalties for these violations may prevent us from giving our client an unqualified certificate. Just how much our ordinary and usual auditing procedures need be extended or supplemented will vary with individual circumstances. In this connection it would be well for all of us to reread bulletin 21 on "Wartime Government Regulations" issued during World War II by the Committee on Auditing Procedure of the American Institute of Accountants. The Committee pointed out in this bulletin "that auditing procedures of the usual examination cannot be expected to provide assurance that a client has complied with all detailed requirements of some of the regulations, such as the War Production Board's priorities requirements and OPA price ceilings . . ." On the other hand the Committee cautions the accountant to be "alert to recognize indications of violations." The Committee goes on to say that "the need for extending the usual procedures will vary with the circumstances, depending upon the relative importance of the consequences of violation on the financial statements, the safeguards provided by the client, the nature of the evidence coming to the attention of the accountant, and possibly other considerations."

If we do detect a significant violation I believe it is desirable for us to inquire closely into the circumstances surrounding the violation with a view to assisting the company to bring itself into compliance with the appropriate regulations and thus avoid fines and penalties. Imposition of the full penalties in some cases could bankrupt a company. In the case of WSB regulations, not only can an unauthorized wage increase be disallowed for Federal income tax purposes, but the entire amount of the wage of which the increase is only a part can be disallowed. In addition, such wages may be disallowed for price control purposes, and for determining costs under any contract made with or on behalf of the government. Penalties for violations of price regulations can be equally severe and may take several forms. First, injunctions can be issued by the courts forbidding further violation of price regulations and may require, in addition, the repayment of the above ceiling charges. Secondly, criminal penalties may be imposed carrying a maximum fine of $10,000 plus one year in jail. Thirdly, buyers' suits for damages may be instituted. In World War II, suits brought by OPA in behalf of buyers formed the bulk of the litigation undertaken by OPA. It is probably that OPS will be equally zealous in bringing buyers' suits for damages under the present regulations.

As I have indicated, our auditing problems with respect to wage, price and other government control are to a large extent one of fact-finding. Our first concern should be to ascertain that these matters are being handled by competent personnel in the employ of the client. This is one of our best assurances that our usual auditing procedures need not be materially extended. Furthermore, we should be able to obtain from such personnel a clear understanding of the particular problems of the client and the procedures which have been instituted in order to comply with the regulations. If the client does not have competent personnel handling the problems of government controls, we should extend our procedures.

With respect to wage and salary controls, an examination of the payrolls and the personnel records provides a good starting point. These records should show that increases granted by the client to his employees since January 15, 1950, have been properly correlated or identified with the appropriate regulations. In some instances we may be able to establish fairly quickly that no violation has occurred. In other cases it may require considerable work on the part of the client to straighten out his records so that the necessary

information is readily available. In the case of price controls, we should ascertain whether the company's price lists have been changed from the date of the freeze and that adjustments therein have been properly keyed back to some section of a price regulation still in force. Tests should be made to determine that these price lists are being actually followed. In some instances the proper application of a given regulation may not be clear. The client will generally find it desirable to obtain opinion from counsel on such matters.

Determining compliance with the regulations issued under the Controlled Materials Plan is not as closely related to the usual audit work of the accountant and therefore we would not normally have to extend our procedures significantly unless we had reason to believe that the company was departing in some material respect from CMP requirements. We should not overlook the fact, however, that allocation of the critical materials, that is, steel, copper and aluminum, can be of vital importance to the economic life of a business, and consequently can have a most important effect on its financial statements. In the course of an audit we should ascertain what procedures the client has set up to insure that he will receive his proper share of critical materials. This information can usually be obtained, at least in broad outline, without an extended investigation. Failure to supply on time the required information under CMP may well penalize the future operations of a company. For example, information to be used by CMP in setting allocations of critical materials in the first quarter of 1952 must be filed by October 1, 1951. A company failing to file by this date may find that it will be allocated less critical materials in the first quarter of 1952 than it otherwise would be entitled to. On the other hand, substantial overstocking of inventories of such critical items should be a warning to us that a given company is probably in violation of CMP requirements.

The last few months have been particularly trying for those who have attempted to keep up with the latest developments in the front line battle of the controls. New regulations, and revisions of old ones, have been an almost daily occurrence. In a way this is to be expected during the formative stages of these control agencies. It is true that they had the experience of the last war to draw upon, but there were plenty of new problems to be handled. I believe we are coming to the end of this period and that we can expect a considerable slowing down in the issuance and revisions of these regulations. This will give everyone an opportunity to become more familiar with their application to specific business situations. However, our difficulties with respect to controls are likely to be increased since it appears probable that inflationary forces will put more and more pressure on wage and price levels. If this happens, controls will become increasingly burdensome. As a further result, accountants and lawyers will be called upon to spend an even greater amount of their time on these problems. Probably we should resign ourselves to this possibility, and study the various government control regulations just a little more diligently.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Dissolution of Real Estate Corporation

The Revenue Act of 1950 added a provision to the Internal Revenue Code permitting a corporation to dissolve within one calendar month during 1951 without subjecting the stockholders to a capital gains tax on the appreciation of corporate assets received by them in liquidation (Sec. 112 (b) (7)). This has resulted in many dissolutions of real estate companies that have sought a means of avoiding a double tax resulting from a sale of property by the corporation.

Such corporations should be fully aware of the New York State tax effects of such liquidations. It should be noted that the New York income tax law has no similar provision. Therefore a stockholder who receives property as a result of a liquidation is immediately subject to capital gain if the property he receives has a market value in excess of the cost of the stock to the stockholder. The transfer of the property to the stockholder in exchange for his stock is a completed transaction resulting in a realization of gain or loss.

One of our members brought this situation to our attention recently. He notes that Sec. 365 (2) provides in part that ". . . in computing gain or loss on the sale . . . of the assets of a corporation that has been dissolved, the basis shall be the same as if such assets had been acquired by the taxpayer at the same time, in the same manner and for the same consideration as they were acquired by the corporation which was dissolved. . . ." If that is so, added our member, then the basis for determining gain to the stockholder is not the fair market value of the real estate but its cost to the corporation.

Section 365 (2) also provides that the above basis for determining gain relates to a case under paragraph (e) of subdivision one of Section 365, and the latter refers to income received during the liquidation of the assets of a corporation after its dissolution. The provisions in Section 365 refer to the tax liability of estates and trusts and to the computation of income of estates and trusts. It frequently happens that a corporation dissolves and transfers its properties to its directors or officers for the purpose of liquidating the assets before making distributions to the stockholders. The liquidating directors or officers thus become trustees. Gains resulting from the liquidation then become taxable to the trustees in their fiduciary capacity. In the hands of the trustees the basis of the property sold by them is the same as it was in the hands of the corporation. This situation is quite different from a direct transfer in kind to a stockholder by way of a liquidating dividend.

In liquidating a real estate corpora-

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tion a taxpayer must not overlook the additional franchise tax of 2% on "the sum of the corporation's actual net worth in excess of its actual paid-in capital . . ." (Sec. 182 2, Art. 9). This is tantamount to a distribution of earned surplus which is a dividend. The actual net worth is determined on the basis of the fair market value of the real estate at the time of liquidation. Both the corporation and the individual stockholders are thus subject to taxes upon the dissolution of a real estate corporation. These taxes should not be overlooked in any plan of dissolution under Section 112 (b) (7).

Capital Gain or Ordinary Income

A taxpayer owned a mortgage of about $30,000. Upon his death the mortgage was valued for estate tax purposes at $5,000. The property was condemned by the city and out of the proceeds of the award the estate received $30,000. The difference of $25,000 was reported to the state as a capital gain. The Tax Commission treated the gain as ordinary income, on the ground that the repayment of the mortgage was not the result of a sale or exchange.

The mortgage obviously was a capital asset of the estate and was one that did not arise out of an income transaction. Ordinarily, the basis for determining a gain is the cost of the asset. In the hands of the executor of an estate the basis would be the value as of the date of death, as shown on the estate tax return. Any recovery in excess of such value is taxable income. If the income is to be considered capital gain the taxpayer must comply with the technical provisions in Section 350 (15) relating to sale or exchange. In the instant case a debt was repaid to the lender and such repayment is not a sale or exchange as contemplated in Section 350 (15) or Article 486 of the Regulations. However, a mortgage is an interest in real estate and is generally given as security for a debt. The creditor really has two assets, a chose in action, the debt, and an interest in real property, the mortgage. Upon payment of the debt the creditor cancels or returns the mortgage to the debtor. This in our opinion spells out an exchange. The mortgage is given up for the payment of the debt. To hold otherwise would do an injustice to the taxpayer.

Abatement of Income Tax for Certain Members of the Armed Forces

The Revenue Act of 1951 provides for the exclusion from gross income of compensation received for active service as a member of the enlisted personnel below the grade of commissioned officer for any month during which such member served in a combat zone after June 24, 1950, and prior to January 1, 1954, or was hospitalized as a result of wounds, disease, or injury incurred while so serving. A like exclusion applies to commissioned officers on the first $200 of compensation received for each month.

Another new provision in the 1951 Revenue Act abates the tax of any individual who dies after June 24, 1950, and prior to January 1, 1954, while in active service or as a result of wounds, disease, or injury incurred while so serving. The abatement applies to all years ending on or after the first day of service in a combat zone after June 24, 1950. If the tax has been collected it shall be refunded.

Under the New York law there is a provision for the exclusion of compensation received by military personnel on and after January 1, 1942, and before December 31, 1952. All such compensation received through April 4, 1944, is exempt, but thereafter the exemption is limited to compensation for active service. In the case of death of a member of the armed forces while in active service, the tax on all of his income for such year is abated.

The next legislature will probably extend this exclusion following the federal provisions.

An amendment to the estate tax law also exempts the estates of service men from the additional estate tax, but not from the basic tax.

Medical Expenses

The Revenue Act of 1951 eliminated the 5% limitation of medical expenses for a taxpayer or spouse if either one attains the age of 65 before the close of the year. The new provision is effective for taxable years after December 31, 1950. There is no similar provision in the State law but the next legislature will probably introduce a similar provision. The maximum deduction for medical expenses on the federal joint return is $5,000. Under the State law it is $1,500.

Payments to Beneficiaries of Deceased Employees

The Revenue Act of 1951 excludes from gross income amounts received under a contract of an employer providing for payments to beneficiaries of an employee, paid by reason of the death of the employee. Such excludible amounts may not exceed $5,000. This provision is made part of Section 22 (b) (1) relating to life insurance proceeds. No similar provision is contained in the New York law, but this is another of the relief provisions that will probably find its way into our statutes.

Retirement of a Partner

A partner in a law firm retired and continued to practice as an individual. Under the partnership agreement his investment in the firm was forfeited to the firm. The retiring partner had paid $22,500 for his interest in the firm and he therefore claimed a deduction for an ordinary loss of that amount. The Commissioner disallowed the deduction and in the alternative alleged that the loss was a capital loss. In the Tax Court[1] the deduction was allowed in full as a loss incurred in a trade or business and not a loss resulting from a sale or exchange of a capital asset.

We believe that the deduction would be allowed in full under the New York State Law as a loss incurred in trade or business rather than as a capital loss. While both the federal and state laws now consider an interest in a partnership as a capital asset there was no sale or exchange and consequently the loss is not a capital loss.

Another issue decided in this case related to the retiring partner's share of the firm's investment in furniture, equipment, etc. During the period that the taxpayer was a partner in the firm, capital assets had been purchased by the firm out of the income reported for taxation by each partner. The firm claimed an annual deduction for depreciation. Upon retirement the taxpayer's unrecovered basis in such assets was about $3,000. Since that too was forfeited the Court allowed a deduction for the undepreciated cost.

A third issue was a loss claimed for taxpayer's share of uncollected fees which were forfeited by his retirement. The Court had no difficulty in disallowing this deduction since the taxpayer was on the cash basis and the fees had never been reported as income. Under the partnership agreement the taxpayer would have received his share of the uncollected fees if he had retired fully from the practice of law or his estate would have received such income in the event of the retiring partner's death. Undoubtedly the retiring partner sustained an economic loss in giving up his right to receive such income, but such a loss is not a taxable loss. The State rule would be the same.

A fourth issue concerned some nondeductible donations that had been made by the firm over a period of years. The retiring partner had included his share of such payments as income. The Court could find no provision in the law giving the taxpayer a right to take a deduction upon his retirement. The

[1] *Palmer Hutcheson*, 17 T.C., No. 4 (July 12, 1951).

contributions, said the Court, did not become capital investments of the firm. We might add that the items would not have been allowed as deductions if they had been made by the individual partners instead of the partnership.

Deduction of Trustee's Commissions upon Termination of Trust

A testamentary trust was set up in 1915. In 1946, under the terms of the will the principal was distributed to remaindermen. The trustee had charged the corpus for his statutory commissions and distributed the net amount. The remainderman took a deduction for such commissions. The deduction was disallowed and the taxpayer took the issue to the Tax Court.[2] The Court sustained the Commissioner. The commissions were not a personal obligation of the remainderman. They were an administration expense chargeable against principal. The remainderman was entitled only to so much of the trust property as was left after satisfying the obligation to pay the commissions. Even if the remainderman had paid the commissions personally, they would not be ordinary and necessary expenses of the remainderman. A trust is a separate taxable entity and the commissions would be an allowable deduction to the trust.

Estate Tax—Survivorship Annuities

A New York City employee was a member of the Mandatory Employee's Retirement System. Upon his retirement he was entitled to a retirement allowance of $3,747.69 a year for his life. Under an option he could take a joint and survivorship annuity which would entitle him to receive $3,140.60 annually for life and at his death his wife would then receive $1,570.20 annually for her life. The employee elected to take the joint and survivorship annuity. He died in 1947.

The State Tax Commission included the annuity in the decedent's gross estate on the theory that when he retired and exercised his option he made a "transfer intended to take effect in possession or enjoyment at or after his death". (Tax Law Sec. 249-r Subd. 3). The executrix argued that the decedent had no "property" in her annuity, that he made no "transfer", that nothing passed at death, and that he retained nothing in his lifetime. This issue was decided in the Surrogate's Court,[3] which held that the selection of the option constituted a transfer of a part of his property rights in the reserve funds. That act was equivalent to a division of the property interests into two parts, one for himself and one for his wife. Upon his death the wife's contingent right ripened into a certainty.

Several additional points of interest were considered in the Surrogate's opinion. Two federal court decisions had reversed decisions of the Tax Court imposing an estate tax upon joint and survivorship annuities[4] and the State usually follows the federal rule in estate tax cases. The Court notes that the reversals were based upon the Technical Changes Act of 1947 and the retroactive features of the act could not be carried over into the New York State Statute because of the constitutional provision which prohibits the giving away of state money for private purposes.[5]

The valuation of the survivorship annuity was also in issue. The Court held that the annuity should be valued as of the date of death of the husband.

Another issue was concerned with the constitutionality of the tax on the annuity which otherwise was properly includible in the gross estate. In 1938,

(Continued on page 858)

[2] *Agnew* v. *Com'r.*, 16 T.C., No. 181 (June 29, 1951).

[3] *Matter of Herman K. Endemann, dec'd.*, Queens County; N.Y.L.J., July 2, 1951, page 190.

[4] *Higg's Estate* v. *Com'r.*, 184 F(2d) 427; *Pruyn's Estate* v. *Com'r.*, 184 F(2d) 471.

[5] Art. VII, Sec. 8, New York State Constitution; *Matter of Harbord*, N.Y.L.J., May 2, 1951, page 1611.

Accounting at the S. E. C.

Conducted by LOUIS H. RAPPAPORT, C.P.A.

Revision of Form S-1

EARLY in 1951, the SEC circulated for comment a proposed revision of Form S-1, the principal form for registration of securities under the Securities Act of 1933. The Commission has now released the revised form. The new form must be used for registration statements on Form S-1 filed with the Commission after 1951; prior to 1952 registrants using Form S-1 may use either the new form or the old.

For accountants the changes of most importance are two in number: (1) the provisions relating to earnings summaries, and (2) the financial statements required where there has been a reorganization or a succession.

Earnings summaries: Most of our readers have seen prospectuses relating to issues of securities being offered for sale to the public. They will know, therefore, that in practically all cases, an offering prospectus contains a condensed summary of earnings in addition to the conventional balance sheets, income and surplus statements. The income and surplus statements generally cover a period of three years plus, in some cases, a recent interim period, whereas the summary of earnings covers a longer period—usually not less than five years and not more than ten years, although some companies with excellent records of earnings have been known to furnish summaries covering 30 years or more.

As we have said above, Form S-1 is the principal form for registering securities under the 1933 Act. It is interesting to note, however, that despite the widespread use of earnings summaries in prospectuses (which are a part of the registration document) there is nothing in the Form S-1 now in use or in any formal rule of the SEC which requires the registrant to furnish a summary of earnings. The practice of including such summaries in prospectuses is so customary, however, that where they have not been included in the initial filing of a prospectus, the SEC has been known to recommend that a summary be included for an appropriate period of years. Thus what came to be regarded as good practice in the preparation of prospectuses, came to be more or less of an administrative requirement of the SEC. That is to say, although there was no item in Form S-1 requiring an earnings summary, it became generally known that the SEC in most instances was of the opinion that one should be furnished. With the revision of Form S-1, this anomalous situation has been rectified; Item 6 of the new form calls for an earnings summary for each of at least the last five fiscal years of the registrant and, in some cases, an interim period following the latest of such years. In elaboration of the time requirement, the instructions provide that the summary shall cover a "representative period." Furthermore, the instructions specify the items to be included in the summary: sales (or revenues), cost of goods sold (or operating expenses) or gross profit, interest charges, income

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taxes, net income, special items, and net income and special items.

Some accountants have questioned the necessity or desirability of revising previously published earnings figures where earlier estimates vary materially from actual amounts later determined, or where there have been significant adjustments in a recent year which have a retroactive effect. As to this matter, the new instructions provide that the earnings summary shall reflect the retroactive adjustment of any material items affecting the comparability of the results.

If the prospectus relates to an offering of common stock, the summary must also show earnings applicable to common stock, earnings per share and dividends declared.

Financial statements where there has been a reorganization or succession: The revised form makes no important changes in the requirements for financial statements of the registrant, consolidated statements, statements of unconsolidated subsidiaries and certain 50% owned companies, or companies whose securities secure an issue being registered. Nor is there any important change in the date of the balance sheets or period to be covered by the income and surplus statement.

Where the registrant has been reorganized, the instructions provide:

> (a) If during the period for which its profit and loss statements are required, the registrant has emerged from a reorganization in which substantial changes occurred in its asset, liability, capital stock, surplus or reserve accounts, a brief explanation of such changes shall be set forth in a note or supporting schedule to the balance sheets filed.
>
> (b) If the registrant is about to emerge from such a reorganization, there shall be filed, in addition to the balance sheets of the registrant otherwise required, a balance sheet giving effect to the plan of reorganization. These balance sheets shall be set forth in such form, preferably columnar, as will show in related manner the balance sheet of the registrant prior to the reorganization, the changes to be effected in the reorganization and the balance sheet of the registrant after giving effect to the plan of reorganization. By a footnote or otherwise a brief explanation of the changes shall be given.

Where there has been a succession, the instructions provide:

> (a) If during the period for which its profit and loss statements are required, the registrant has by merger, consolidation or otherwise succeeded to one or more businesses, the additions, eliminations and other changes effected in the succession shall be appropriately set forth in a note or supporting schedule to the balance sheets filed. In addition, profit and loss statements for each constituent business, or combined statements if appropriate, shall be filed for such period prior to the succession as may be necessary when added to the time, if any, for which profit and loss statements after the succession are filed to cover the equivalent of the period specified [three years plus, in some cases, an interim period].
>
> (b) If the registrant by merger, consolidation or otherwise is about to succeed to one or more businesses, these shall be filed for the constituent businesses financial statements, combined if appropriate, which would be required if they were registering securities under the Act. In addition, there shall be filed a balance sheet of the registrant giving effect to the plan of succession. These balance sheets shall be set forth in such form, preferably columnar, as will show in related manner the balance sheets of the constituent businesses, the changes to be effected in the succession and the balance sheet of the registrant after giving effect to the plan of succession. By a footnote or otherwise, a brief explanation of the changes shall be given.
>
> (c) This instruction shall not apply with respect to the registrant's succession to the business of any totally-held subsidiary.

Omission of income and earned surplus statements in certain cases: A new instruction provides that if the earnings summary is certified for the required period and contains, as is now frequently the case, the same information that would be contained in a conventional income statement, the latter statement need not be included either in the prospectus or elsewhere in the registration statement. Also, if the summary is certified for the required period and contains the same information that would be contained in a conventional statement of earned surplus, the latter statement need not be included either

in the prospectus or elsewhere in the registration statement.

Important changes not affecting financial statements: The revised form permits the omission from the prospectus of certain information which has heretofore been required to be set forth in the prospectus, but requires such information to be furnished elsewhere in the registration statement. For example, it is no longer necessary to include in the prospectus a detailed description of the underwriting arrangements. All that is required in this respect is the names of the managing underwriters and a statement as to whether such arrangements constitute what is commonly referred to as a "firm commitment" or whether they are in the nature of agency or "best efforts" arrangements. Further details with respect to the underwriting and marketing arrangements are required to be otherwise furnished in the registration statement. In other cases, information heretofore required in the prospectus is permitted to be entirely omitted from the prospectus and set forth elsewhere in the registration statement. This treatment, for example, is accorded information with respect to franchises and concessions, indemnification of directors and officers, and bonus and profit-sharing plans for management.

In releasing the new form, the SEC said:

> "The Commission believes that the use of the revised form should result in a more concise and businesslike selling prospectus which can be widely distributed and more easily understood by the average investor. The extent to which this goal is achieved will, however, depend in large measure upon the cooperation of the industry. It will be necessary for the issuer, the underwriters and their lawyers and accountants to cooperate in the preparation of the prospectus by eliminating duplication, unimportant or mechanical details, statistical or other information not called for by the form and not material from the standpoint of investors. If the prospectus is to serve its purpose it must not be prepared with a view to making it a detailed book of reference with respect to the issuer and its securities. The Commission and its staff will upon request cooperate to the fullest extent in pointing out in particular cases the extent to which it is deemed possible to accomplish the desired result and thereby make the prospectus more useful to investors."

Notes on the New York State Unemployment Insurance Law

Conducted by SAMUEL S. RESS

FOUR cases decided recently* by a New York State Unemployment Insurance Referee demonstrate the importance of complying strictly with the new provisions of the Unemployment Insurance Law regarding requests for hearings by employers who wish to contest a former employee's right to receive unemployment benefits. In all four decisions the employer was barred from obtaining a hearing because of failure to comply with the provisions of section 620 of the New York State Unemployment Insurance Law.

The law provides that "any employer who requests a hearing upon an initial determination with respect to a claim for benefits shall at the *same time* deliver to the commissioner a deposit in the amount of ten dollars . . ." (underscoring supplied) and that the request for a hearing and delivery of deposit are to be made within "twenty days after mailing or personal delivery of notice of such determination . . ."

Ordinarily, when an employer requests a hearing for the purpose of objecting to an initial determination by the Industrial Commissioner that a former employee was eligible for benefits, the Unemployment Insurance Office sends the employer a "Notice of Deposit Required for Hearing." That notice directs the employer to forward his check payable to the "Employers Hearing Deposit Account." If the Referee should overrule or modify the initial determination, the deposit will be refunded to the employer. Otherwise, the $10.00 is forfeited.

It is important to note that a separate $10.00 deposit must be paid for each individual claim even though the same issue may be involved in all the claims that the employer wishes to contest.

Employer's Right to Cross-Examine

The Unemployment Insurance Appeal Board recently ordered three cases (Appeal Board Case Numbers 24,629-50; 24,630-50, and 24,631-50, decided Sept. 28, 1951) remanded to the Referee for a decision *de novo* after a new hearing, because the employer was not given an opportunity to appear at a hearing for the purpose of cross examining witnesses.

The Industrial Commissioner had held that the employer corporation was subject to the Unemployment Insurance Law from June 23, 1947, and liable for an assessment for contributions in the sum of $4,163.03. A sec-

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Dr. Ress, who has written a number of articles which have appeared in *The New York Certified Public Accountant*, is a member of the Society's Committees on Clothing Manufacturing Accounting and on Labor and Management.

* Case #519-637-51R, decided Nov. 5, 1951; case #535-452-51R, decided Nov. 2, 1951; case #519-603-51R, decided Oct. 26, 1951; case #519-602-51R, decided Oct. 29, 1951.

ond employer involved in the proceeding was held subject from April 8, 1946, and liable for $2,103.44. He had ruled further that a claimant was entitled to benefits on the basis of earnings with the employers.

At the hearing scheduled before the Unemployment Insurance Referee, the claimant appeared but the alleged employers did not. They had requested an adjournment. The Referee nevertheless proceeded to take the testimony of the claimant, and the appellants were thereby deprived of an opportunity to cross-examine the claimant with respect to testimony given by him. At the conclusion of the hearings, the Referee held that the employers had been subject to the law and were liable for the tax assessments of $4,163.03 and $2,103.44. He also ruled that the claimant was entitled to benefits.

Both employers appealed from the Referee's decision. The Appeal Board held that " . . . It appearing to be in the interest of justice, this case should be remanded to the Referee for a decision *de novo* because of the fact that the appellants were deprived of an opportunity to cross-examine the claimant in connection with his testimony given before the Referee . . ."

The Referee was ordered to hold a new hearing after giving proper notice to all interested parties and to render a new decision as a result of the new hearing.

Unsalaried Corporate Officers Not Employees

Another recent case (Appeal Board #26,675-51, decided October 5, 1951) held that an officer of a corporation who received no salary and performed no services for the corporation was not to be considered an employee of the corporation.

In this case the employer operated a retail store as a closed corporation. The officers were the president and his mother. The mother received no pay and rendered no services, but had the power to sign checks which power she never exercised. The president alone signed checks. The wife of the president of the corporation was also empowered to sign checks because of the illness of the mother. The employer contended that the minutes of the corporation did not contain any resolution as to the salaries of the officers. The books of the corporation did not disclose that any salary was paid to the president of the corporation who performed services. The Appeal Board found that the accountant for the firm had recorded the president's salary in the firm's record books in the name of his wife, whom he designated as the Secretary, even though his mother was actually the Secretary of the corporation.

The Industrial Commissioner held that the president, his wife, and two other conceded employees, were all covered employees and that the firm was liable for $956 on their wages.

The Appeal Board decided that there was no evidence in the record to sustain a finding that the wife of the president of the corporation was an employee and that the entries on the books which indicated that cash payments had in fact been paid to the wife who performed no service were actually salary payments to the president as the sole active officer of the corporation.

* * *

Mr. Milton O. Loysen, Executive Director of the New York State Division of Placement and Unemployment Insurance, and Mr. Ben Cooper, of the New York City and Metropolitan Area District of that Department gave the members present at the Society's November membership meeting an excellent exposition of the philosophy behind the wordy and difficult language in the new Unemployment Insurance Law and explained the practical application of the law. I recommend for the "must" reading list of all members of the Society and their staffs, the excellent "Handbook for Employers" and "Plan of Operations and Key Forms under the Unemployment Insurance Law, as amended, 1951" distributed to the members present at the meeting.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Prompt Handling of Confirmation Replies

CONFIRMATIONS of accounts receivable balances often bring swarms of replies. Unless these responses are dealt with very promptly they will delay the completion of reports. The problem is aggravated by the fact that time must be provided in which to send out second requests and await the responses.

Certain measures are helpful in alleviating this condition, such as using negative accounts receivable confirmations for balances below a certain size (such forms require a response only in the event of a difference) and the staggering of confirmations throughout the year.

Nevertheless, where the responses are very large the adoption of efficient office mechanics should speed up the review of the responses, the inquiry into differences, and the determination of the second request mailings that are to be made. This can be accomplished by having juniors (those who are office-trainees or others) assigned to open all confirmation replies and to assort them first by clients and then by type of confirmation. By turning over to the "confirmation crew" lists of the customers balances, using a duplicate list if necessary, they can promptly check off the items that are in agreement and segregate those that have differences. The unanswered requests will, obviously, be readily ascertainable.

Even before the auditors get around to the details of the audit the differences can be communicated to the client with the request that they be checked out. Thus, when the accountants arrive on the job they may find the differences fully or substantially resolved. Further, they will then have available the names of the delinquent confirmees so that they may promptly send out second requests in the hope that responses will be received early enough for timely delivery of the report.

There are further refinements in the mechanics which can be worked out. For example, one may arrange to send out second requests within two weeks after the first mailing. Thus it is possible, in instances where the major audit effort doesn't get under way for two or three weeks after the closing date, that even the second requests will be out in the mail before the job really gets under way.

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Tax Return Preparation Economies

An accounting firm recently sent in for review certain ideas that it is considering which, it believes, may reduce the burdens of tax return preparation. Though certain difficulties are visualized, the ideas are nevertheless indicative of the ingenuity that must be exercised to contend with increasing paper work and higher operating costs.

The plan contemplates the use of white, photographic copies, size 17 x 13, of Form 1120, the federal corporation income tax return. Prior to photographing the form, they intend to rule it up fully with lines for dollars and

cents. The proposed form should facilitate preparation of such returns because of its advantages over the present colored and partly ruled tax blank. Incidentally, the typists should find it easier to copy from the suggested form.

Additional advantages visualized are that the form will be the correct size for filing in legal size cabinets, whereas the present form must be folded and requires twice as much space and more handling time.

Another contemplated time saving measure involves the photostating of pencil copy supporting schedules, thereby saving valuable typists' time and eliminating the need for proofreading.

Comments of readers on the foregoing ideas are solicited and other time-saving plans now in use will be very welcome.

How Long Should Tax Records Be Kept?

A valuable article on this subject appears in the November, 1951, issue of *"Taxes—The Tax Magazine"*, entitled "How Long Should Records Be Kept", by George T. Altman. Though intended for the taxpayer, it is nevertheless helpful to accountants in two ways. First, it is an aid in determining record retention advice to be given clients; second, it may be of some help to accountants in the determination of their own record retention policies.

"Small Business" Enlarged

The United States Department of Commerce recently issued a new definition of small business (manufacturing) which radically changes the old working definition of "fewer than 500 employees" used by government agencies generally.

Under the new Commerce Department ruling a company may be small if it employs up to 2500 workers in some industries yet may be large if it employs more than one hundred in others. No specific industry citations were made, thereby leaving the application of the rule to be made on practical grounds.

Accountants will be interested in this change insofar as it may affect any of their clients who may seek certain of the "small business" benefits available as emergency measures.

Sight-Saving Ideas

In the October, 1951, issue of the Journal of Accountancy there is a very practical article entitled "Accountants Need Not Suffer Eyestrain." The article is short and should be read by every accountant. In addition to other material of interest it cites the following code of good lighting and reading rules promulgated by the National Society for the Prevention of Blindness:

1. Sit erect, and arrange your work about 14 to 16 inches from your eyes.
2. Give your eyes a rest from time to time as you work, close them for a few seconds, or focus on an object in the distance.
3. Use light which is shaded at the eye-level, and diffused over a wide area.
4. Avoid glare and reflection from polished surfaces.
5. Don't read in the direct sunlight, but make the most of indirect sunlight in your office or home by using light shades and drapes.
6. Have as little contrast as possible between the brightness of the surrounding area and the brightness of your desk. In other words: light in the room where you are working should be almost as strong as the direct light on your desk.

Naturally one's thoughts should also run to the adequacy of staff room lighting and private office facilities. Some of the electric companies provide, free of charge, a light engineering check-up, to determine whether the office lighting facilities are adequate according to scientific standards.

It may also be helpful, on occasions, to remind staff men to have their eyes checked. It is well established that eyestrain is responsible for superficial work, impatience with work, and for errors.

The Excess Profits Tax Exchange

Conducted by DAVID ZACK, C.P.A.

THIS column is a clearing house for questions, problems and comments regarding Excess Profits Taxes. Items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified Public Accountant
677 Fifth Avenue
New York 22, N. Y.

Interim Accruals

Jacob Heskes, C.P.A., of Leon Lipton and Company, submits the following computations which should prove helpful in the accrual of income taxes in connection with the preparation of interim reports.

"In the April, 1951, issue you discussed the problem of estimating excess profits tax liability on interim reports. The attached tables represent our *practical* resolution of this problem.

"Faced with the absolute necessity of approximating the Federal Income, Excess Profits, and New York State Franchise tax liabilities of a large number of calendar year corporations monthly, we have reduced all three taxes to a single set of effective brackets and rates.

"Inasmuch as these tables are for use with interim reports, we have disregarded the numerous minor adjustments involved, and have considered the New York State Franchise Tax to be a straight 5½%, and the Excess Profits Net Income equal to the Net Income after New York State Franchise Tax. No provision has been made for deduction of the previous year's franchise tax since the error is insignificant, amounting to an overstatement of total tax liability equal to approximately 2½% of the previous year's franchise tax. The tables also do not apply to 'new' corporations or fiscal year corporations which require rate proration. However tables similar in set-up can be prepared for these cases.

"Although an exact determination of the excess profits credit for the taxable year is impossible before the year ends, adjustment of the previous year's credit for any unused excess profits credit, change in equity capital, and for changes made by the new tax law and Revenue Agents Reports, should provide a workable approximation.

"As an example, where the taxpayer's excess profits credit for the calendar year 1951 amounts to $100,000, the table becomes:

$ –0–	to $ 26,455	.3266875 I
26,455	to 105,820	.5345875 I—$ 5,500
105,820	to 248,988	.8180875 I—$35,500
248,988	and up	.6976 I —$ 5,500

DAVID ZACK, C.P.A., is a member of our Society and of its Committee on Federal Taxation. He is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is a member of the New York Bar, the Federal Bar, and the Tax Bar. He is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration where he developed an intensive course on the New Excess Profits Tax Act.

Mr. Zack has written on tax matters for various publications. He is engaged in tax practice with a prominent New York firm of certified public accountants.

"If the taxpayer's interim income before New York State Franchise Tax amounts to $150,000, he falls in the third bracket, and his total state and federal tax liability at the interim date is:

	$ 150,000
multiplied by	.8180875
	$ 122,713
minus	35,500
	$ 87,213

TABLES

Net Income before New York State Franchise & Federal Income & Excess Profits taxes	*Total New York State Franchise & Federal Income & Excess Profits taxes*
1951 (Prior Law)	
$ –0– to $ 26,455	.29125 I
26,455 to 1.0582 X	.49915 I — $5,500
1.0582 X to 2.1164 X + $38,800	.78265 I — $5,500 — .30 X
2.1164 X + $38,800 and up	.6409 I
1951 (New Law)	
$ –0– to $ 26,455	.3266875 I
26,455 to 1.0582 X	.5345875 I — $5,500
1.0582 X to 2.489885 X	.8180875 I — $5,500 — .30 X
2.489885 X and up	.6976 I — $5,500
1952	
$ –0– to $ 26,455	.3385 I
26,455 to 1.0582 X	.5464 I — $5,500
1.0582 X to 2.6455 X	.8299 I — $5,500 — .30 X
2.6455 X and up	.7165 I — $5,500

(*X* is the Excess Profits Credit for the year. *I* is the Net Income before New York State Franchise Tax and Federal Income and Excess Profits Taxes.)"

It should be noted that the tables set forth above, albeit very helpful for purposes of computation, in no way help to solve the underlying problems of basic theory discussed in the April, 1951, column.

New Corporations

The Revenue Act of 1951 enacted some substantial benefits for "new corporations". The following question from an upstate reader highlights some of these new provisions:

"Corporation C incorporated December 1945 and filed its first return for the calendar year 1946. For the calendar year 1950, the net income before provision for federal income taxes was $38,000. The excess profits base is a flat $25,000 with no adjustments.

"As I read the tax regulation under the Revenue Act of 1951, there appears to be a new ceiling rate for new corporations. In the calender year 1950 which would be the fifth year of a new corporation the ceiling rate is 14%. Since this particular corporation paid excess profits for a half year of 1950, amounting to 15%, there appears to be a refund applicable to this case.

"Based on the above facts, in your opinion, assuming all other items being accepted as filed, is there a possibility of a refund for the calendar year 1950? What base do you apply the 14% maximum tax to? Is it multiplied by the amount in excess of $25,000 in this case? If so, the tax saving would be the difference between the 14% and the 15% as paid, which would not be worth bothering with.

"Do I understand it correctly, that at the end of the new corporation's fifth business year, the maximum tax formula ceases to operate. I would assume further in this case that the first year of the corporation's business would be the calendar year 1946."

Section 435(e) of the Internal Revenue Code, added by the Revenue Act of 1951, provides special excess profits tax limitations for "new corporations".

These limitations apply only for the taxpayer's first five taxable years. Section 435(e)(2)(A) specifically provides that the taxable years are computed from the year in which the taxpayer "commenced business". The question indicates that corporation C did not commence business until the calendar year 1946, so that its fifth taxable year would be the calendar year 1950. The question therefore correctly assumes that the special maximum tax limitation for new corporations would not apply to corporation C after the calendar year 1950.

The maximum limitation of 5% the first and second year, 8% the third year, 11% the fourth year and 14% the fifth year, is applied to the first $300,000.00 of *excess profits net income*. "Excess profits net income" is computed prior to any reduction for the excess profits credit and/or the unused excess profits credit carry-back or carry-forward. In the case of corporation C, therefore the 14% limitation would be applied to the $38,000.00, which is apparently the corporation's excess profits tax net income. The limitation provided by Section 435(e) would therefore not apply inasmuch as the regular tax on the adjusted excess profits net income of $13,000.00 would be much less than the maximum limitation. Our reader would therefore have no refund available in the instant case.

New York State Tax Forum

(Continued from page 848)

the State Constitution for the first time expressly provided that all "salaries, wages and other compensation, *except pensions*"[6] paid to employees of the state and its subdivisions were subject to taxation. Under this provision in the Constitution, said the Surrogate, the widow's annuity was exempt from estate tax. If the unexpended reserve had been made payable by direction of the decedent to his estate or to a named beneficiary, that amount would not have been exempt from estate taxation according to an earlier decision.[7]

Sale of Residence

Under the Revenue Act of 1951 no gain will be recognized on the sale of a residence if a taxpayer purchases a new residence within one year prior to the sale or one year after the sale, except to the extent that the selling price of the old residence exceeds the cost of the new one. If the new residence is one being constructed by the taxpayer he must use the new property as his residence within 18 months after the sale. The new provisions apply to the purchase or sale of stock in a cooperative apartment corporation, to a trailer, or to a houseboat.

The basis for determining subsequent gain for the new residence must be adjusted for the amount of gain not recognized upon the sale of the old residence.

The New York law taxes a gain on the sale of a residence, but it also allows a deduction for a loss, something the federal law does not do. The new federal treatment of a gain is more equitable and realistic and should be adopted by the State.

Interest on Tax Claims in Insolvency Proceedings

In the May, 1951, issue of the State Tax Forum, page 362, we stated that the Appellate Division for the First Department had held that in the case of a general assignment for the benefit of creditors the Federal Government and the State of New York were entitled to interest on tax claims not only to the date of assignment but to the date of distribution. This Appellate Division decision has been reversed on appeal by the Court of Appeals,[8] which held that the general rule that interest stops on claims of creditors at the date of assignment applies to tax claims of the federal and state governments.

[6] Article XVI, Section 5.
[7] *Matter of Riegelmann*, 178 Misc. 473.
[8] *Pavone Textile Corp.* v. *Bloom*, 302 N.Y. 206, March 8, 1951.

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